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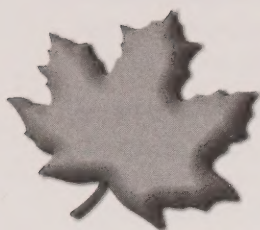
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DEBT MANAGEMENT STRATEGY

1998-99



DEBT MANAGEMENT STRATEGY

1998-99



Department of Finance
Canada

Ministère des Finances
Canada



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Foreword by the Minister of Finance

On February 24, 1998, the government announced a fiscal victory for all Canadians – the elimination of the federal deficit. Perhaps more importantly, it also announced that for the first time in nearly 50 years, the budget would also be balanced for the two years after that – in 1998-99 and 1999-2000.

Indeed, if Canada used the same less stringent yardstick as other countries to measure its deficits – financial requirements, or the amount of new money borrowed from the market – then we could have declared victory even earlier: a year earlier, in fact. In 1996-97 we were the only G-7 country to record a surplus in financial requirements. And we will do so again and again, year after year.

What this means is that the age of chronic deficits is over and that the age of debt reduction has begun.

The government is committed to reducing the debt burden. By concentrating on a balanced approach, we will ensure a growing economy that will result in a persistent lessening of the debt-to-GDP ratio. Moreover, the government has outlined a Debt Repayment Plan that will bring down the absolute level of the federal debt. This plan includes the continued use of two-year fiscal forecasts and prudent planning assumptions, the maintenance of an annual \$3 billion Contingency Reserve and the application of that reserve to the debt when it is not required for other uses. Lastly, the government will continue to maintain a prudent debt structure – one designed to protect the fiscal plan against unexpected changes in the economic and financial landscape.

As the government continues to run financial surpluses, market debt will be reduced. Market debt programs will be adjusted gradually, in consultation with market participants, and initiatives will continue to be undertaken to ensure the integrity of the market. The government's objective is to maintain a liquid and well-functioning market for Government of Canada securities.

This document shares with Canadians how that challenge will be met successfully. I hope that this new publication – arising from the dawn of a new fiscal age – will contribute to a broader and better understanding of the government's plans to reduce and manage Canada's debt.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
March 30, 1998

Overview

The *Debt Management Strategy* is a new annual publication of the Department of Finance. It provides information on the federal government's debt management strategy for the coming fiscal year.

The government's intention in issuing the *Debt Management Strategy* is to ensure the strategy remains transparent and well understood.

The government will also continue to publish the *Debt Management Report* shortly after the release of the Public Accounts in the fall. Its focus will be to report on the federal government's debt operations over the previous fiscal year, and to provide detailed information on the government's outstanding debt.

Debt Management Framework

This section outlines the federal government's objectives in managing the federal debt and the key principles underlying the pursuit of these objectives.

Debt Management Objectives

The fundamental objective is to raise stable, low-cost funding for the government.

- The fundamental debt management objective is to raise stable, low-cost funding for the government.
- A key strategic objective is the maintenance of a well-functioning market for Government of Canada securities.

Domestic Debt Management

Principles

All funding required for the government's operations is raised in the domestic market.

- Funding required for the government's operations is raised in the domestic market and in all major maturities.
- The government borrows on a regular, preannounced basis. Debt management decisions are independent of the government's outlook for domestic interest rates.
- The government focuses on liquidity, transparency, regularity and market integrity in its efforts to maintain a well-functioning market.

General Strategy

- The debt stock is structured prudently to ensure reasonable cost stability under a range of potential interest rate environments.
- The government maintains a broad investor base and active relations with investors and credit rating agencies.
- Adjustments to the domestic debt programs are made gradually, following consultation with market participants.

Foreign Currency Debt Management

Principles

Foreign currency debt is issued to raise foreign exchange reserves.

- The government borrows in foreign currencies, mainly in U.S. dollars, as required to fund Canada's foreign exchange reserves.

General Strategy

- The government raises foreign exchange reserves through a range of sources and investors. The liabilities are managed in conjunction with the assets to limit the cost of carrying reserves, and to maintain a prudent maturity structure.

Debt Management Environment

Changing Debt Structure

Federal debt management is entering a new era of financial surpluses and a declining stock of market debt.

The last four years have seen significant changes in the composition of the debt.

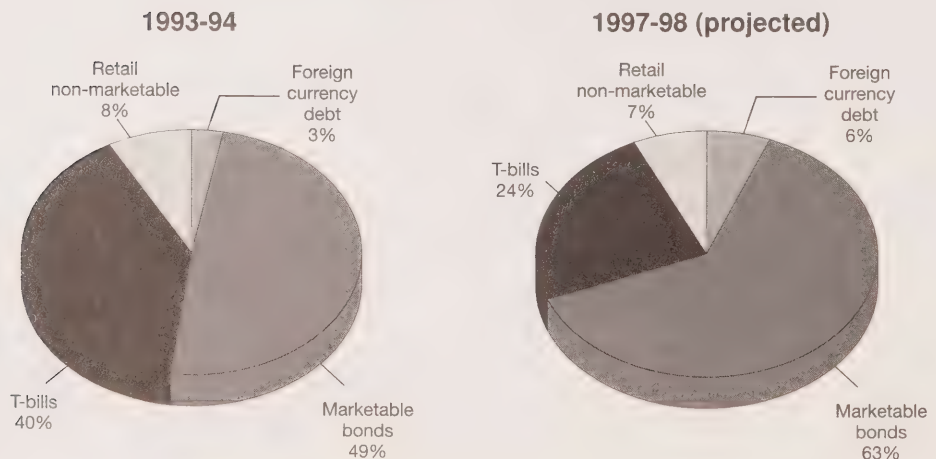
With the elimination of the deficit this fiscal year and the commitment to balanced budgets for the next two years, debt management has entered a new era. The 1998 budget outlook for financial requirements (excluding foreign exchange transactions) in 1997-98 is a surplus of \$12 billion. It is expected that domestic market debt will fall by this amount. This is a dramatic change in the debt management environment from four years ago.

- As recently as 1993-94, the federal government recorded a financial requirement (excluding foreign exchange transactions) of \$30 billion and had net domestic borrowings of \$26 billion (i.e. the stock of domestic market debt increased by \$26 billion).

The composition of market debt has also changed significantly over the past four years (see charts below) due to the decision to increase the portion of the gross debt in fixed-rate form from 55 per cent to 65 per cent in order to protect the government from the fiscal effects of unexpected increases in interest rates. Reaching this objective was made easier by the dramatic turnaround in the federal government's fiscal situation.

- The stock of marketable bonds has increased from \$203 billion (49 per cent of market debt) at the end of 1993-94 to \$294 billion (63 per cent of market debt) at the end of 1997-98.
- The Treasury bill stock has declined from \$166 billion (40 per cent of market debt) at March 31, 1994 to \$113 billion (24 per cent of market debt) at March 31, 1998.

Composition of Market Debt
(% of total market debt at fiscal year-end)



Fiscal Outlook: Implications

The budget outlook is for a balanced budget in the coming years.

On February 24, 1998, the Minister of Finance announced a balanced budget in 1997-98, and the government's commitment to balanced budgets in 1998-99 and 1999-2000.

The Minister also announced the government's commitment to lower the overall burden of public debt. This will be done through a two-track strategy: the government will continue to follow policies that will pay off in better economic growth, and it will bring down the absolute level of debt through a Debt Repayment Plan. The Plan is based on three key elements:

The overall level of federal debt may fall.

- as before, two-year fiscal plans based on prudent economic planning assumptions; the current plan commits to balanced budgets in 1998-99 and 1999-2000;
- the inclusion in the fiscal plan of a Contingency Reserve of \$3 billion in each year; and
- the use of the Contingency Reserve, when it is not needed, to pay down the public debt.

Financial surpluses will give rise to reductions in the market debt stock and a need for gradual restructuring of market debt programs.

The 1998 budget also projects financial surpluses of \$6 billion in 1998-99 and \$9 billion in 1999-2000. The financial balance provides a measure of the cash requirement to fund the government's programs and debt charges – a financial requirement represents a positive cash requirement whereas a financial surplus represents a negative cash requirement. The cash requirement is funded with market debt. Market debt includes marketable bonds, Treasury bills, retail non-marketable debt (primarily Canada Savings Bonds) and foreign-currency-denominated bonds and bills.

Ongoing financial surpluses mean that there will be a significant, ongoing decline in market debt. As a result, market debt programs will need to be gradually restructured. In this context, priority will be given to the maintenance of a liquid and well-functioning Government of Canada securities market, as well as ensuring the integrity of the market.

The difference between the financial surplus and a balanced budget reflects a number of accrual adjustments made to expenditures and revenues in the calculation of the budgetary balance. These accrual adjustments do not affect the financial balance because they do not require immediate cash payments. The largest of these accrual adjustments relates to the government's liabilities for public sector pensions. The accumulation of these accrual adjustments comprises the other portion of the debt – this portion is commonly referred to as non-market debt.

Pension reform may lead to additional market borrowing.

Non-market debt will continue to increase over time, reflecting higher public service pension plan liabilities. The government has indicated its intention to consider reform of the public service pension plans. The reform may involve the replacement of some of the government's internal funding with market funding and, as a result, would reduce the pace of the reduction in market debt.

A well-functioning Government of Canada securities market is important to all market participants.

Government of Canada Securities Market

A well-functioning Government of Canada securities market provides low-cost financing for the government. It is also of general benefit to the domestic capital market where federal securities are key investments, as well as pricing and hedging tools.

The Government of Canada securities market is one of the most liquid and efficient sovereign markets in the world, featuring tight bid-offer spreads, large transactions volumes, and high turnover ratios. While marketable debt is expected to decline over time, the government's priority will be to ensure that the Government of Canada securities market continues to be highly attractive to investors.

A number of recent developments, including growing levels of concentration and the declining supply of new debt, are creating challenges for the management of the Government of Canada securities market. This is reflected by the occurrence of infrequent, but highly undesirable "squeezes"¹. Squeezes reduce the incentive for dealers and investors to participate actively in the Government of Canada securities market. If steps are not taken, this could lead to reduced participation which would raise the cost of federal government borrowing. This, in turn, would affect other market participants who rely on a liquid and efficient Government of Canada securities market.

The government is responsible for the functioning of the primary market.

It is clearly in the public interest to ensure that integrity of the Government of Canada securities market is maintained. In this regard, the government distinguishes between the primary market (auctions), where it bears responsibility, and the secondary market, where the responsibility for maintaining a well-functioning market is shared by all market participants. The government is proposing changes to the auction rules designed to prevent squeezes from occurring at auctions, and the Investment Dealers Association is developing a Code of Conduct. Details on the initiatives underway to enhance market integrity are detailed in a later section of this report.

¹ A squeeze occurs when one or more market participants gain control of the stock of a security and use the controlling position to manipulate prices.

1998-99 Debt Management Strategy

Maintaining a prudent debt structure

With a still-large debt stock, maintaining a prudent debt structure remains a priority.

While the elimination of the deficit represents a major achievement, the level of debt remains significant and must come down. Canada's debt stock is exposed to interest rate changes originating in Canada and around the world. Interest rate shocks can significantly affect the level of annual debt charges, as the portion of debt that is rolling over must be issued at the new prevailing market interest rates. Some \$200 billion of the federal market debt will be maturing or repriced over the 1998-99 fiscal year. The continued success of the government in achieving low interest rates should prove beneficial to Canada in this respect.

Nonetheless, a prudent debt structure is essential in protecting the government's fiscal position from unexpected increases in interest rates, as well as moderating refinancing risk. A prudent debt structure is one that provides reasonable cost stability under a range of economic scenarios. Such a structure also maintains investor and credit rating agency confidence.

The fixed target is being slightly increased in 1998-99 for prudent financial management reasons.

In 1995, the government set a target for the fixed-rate share of the debt² of 65 per cent – it was achieved in 1997-98. This means that a 100-basis-point increase in interest rates would now raise public debt charges by \$1 billion in the first year; in the mid-1990s, the first year impact of a 100-basis-point increase was estimated at about \$1.8 billion.

A key debt management undertaking over the last months was to review the target and assess its ongoing suitability. The government has decided to increase the target slightly – the objective will be to have 2/3 of the debt in fixed-rate instruments. This reflects the government's preference for greater prudence in its debt structure and provides increased operational flexibility.

Operationally, it is very difficult to maintain the debt at a precise fixed-rate proportion. Large maturing bond benchmarks will cause short-term variance in the fixed ratio. Rather than maintain a precise fixed-rate target, the government will manage the fixed-rate proportion of the debt around the new target.

Further diversification of the investor base will be pursued through CI&S, the government's retail debt agency.

A further strategy to increase cost stability has been to diversify the investor base for Government of Canada securities. By having a diversified investor base, the stock of debt is less exposed to interest rate changes caused by shifts in investor preferences. An ongoing initiative in this context is the work being done by Canada Investment and Savings (CI&S), the government's retail debt agency, to diversify the retail debt stock and broaden the retail investor base. CI&S will continue to provide individual Canadians with greater opportunity to invest in Canada. This will be accomplished by the continuing development of investment and savings products that Canadians want.

² The fixed-rate share of the debt is the percentage share of the gross debt that matures or is being repriced in more than one year.

Maintaining and Enhancing a Well-Functioning Market

Debt Program Design

The government will maintain the principles of liquidity, transparency and regularity in its operations.

Liquidity, transparency and regularity are the principles underlying the maintenance of a well-functioning market. The federal government is committed to maintaining these principles as the level of market debt declines.

To ensure transparency and regularity, the government will continue to borrow in the domestic market on a regular, preannounced basis. In 1998-99, the government will continue the practice of holding regularly scheduled quarterly auctions of 2-, 5- and 10-year bonds. As part of our continuing and gradual restructuring of the bond program, the frequency of issuance of 30-year bonds will be reduced to two times per year from four times per year.

A bond buy-back program is being introduced on a pilot basis to improve primary market liquidity.

To enhance bond market liquidity, the government plans to implement a bond buy-back program on a pilot basis in 1998-99. The purpose of this program is to buy back existing, less liquid bonds to support the maintenance of a liquid new issue market. The intent of the pilot program this year is to have no major impact on the level of bonds outstanding at year-end – thus there is the potential, later in 1998-99, for an additional bond auction to be inserted into the calendar. The government will consult with market participants on the design of the pilot program and will announce the details well in advance of its implementation.

Gradual adjustments will be made in consultation with market participants.

Looking further ahead, the government's plan is to adjust domestic debt programs over time in such a way that the market is not disrupted unduly. The government will be proceeding on a gradual basis, in close consultation with market participants.

Enhancing Market Integrity

Changes to the auction rules are being proposed to improve the functioning of the primary market.

The government is also undertaking a number of initiatives to enhance market integrity.

With respect to the primary market (auctions), the Department of Finance, in conjunction with the Bank of Canada, will be releasing very shortly a discussion paper outlining proposed changes to the auction process for Government of Canada securities. The proposals reflect comments received in response to a discussion paper issued in December 1996. They focus on changes to the auction rules, as well as an increase in the Bank of Canada's monitoring of the bond and Treasury bill markets. The proposals are designed to ensure that the auction process is competitive, transparent and fair.

Initiatives with the private sector are underway to improve the integrity and transparency of the secondary market.

With respect to the secondary market in Government of Canada securities, the Department of Finance and the Bank of Canada are working closely with the Investment Dealers Association (IDA), as it develops a Code of Conduct for IDA members. The Code sets a high standard of behaviour for all market participants.

The government also continues to provide support for improved secondary market price transparency. The IDA and the Inter-Dealer Brokers Association are currently in the process of developing a screen-based information system on prices and trades in the secondary market in Government of Canada securities.

A legislative review will be undertaken.

The government plans to review the statutory framework for federal debt management. The review will focus on the need to modernize the government's debt management authority and to clarify its capacity to address integrity concerns in the Government of Canada securities market.

1998-99 Federal Debt Programs

Plans for the market debt programs are based on the 1998 budget outlook.

The federal government uses a variety of instruments to fund its operations:

- fixed-rate marketable bonds;
- Real Return Bonds;
- Treasury bills; and
- retail debt (primarily Canada Savings Bonds).

The foreign currency borrowing program is used to fund Canada's foreign exchange reserves.

The plans for each debt program in 1998-99 are presented below. The plans are based on the 1998 budget outlook for financial surpluses (excluding foreign exchange transactions): the forecast is \$6 billion for 1998-99, and \$9 billion for 1999-2000.

The changes are consistent with the government's intention to make gradual adjustments, and to maintain a high standard of liquidity and transparency. They incorporate feedback received from market participants.

Fixed-Rate Marketable Bonds

The planned bond program for 1998-99 will be modestly lower than in 1997-98.

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. The outstanding stock of these bonds is projected to be \$285 billion at March 31, 1998, up from \$275 billion at March 31, 1997. Of the total amount outstanding, \$36 billion of bonds will be maturing in 1998-99.

1998-99 Program

Quarterly issuance of the 2-, 5- and 10-year maturities will be maintained ...

- Given the declining needs of the government, the fixed-rate bond program (i.e. gross issuance) is planned to be modestly lower than the \$38 billion gross program in 1997-98.
- Regular, quarterly issuance of the 2-, 5- and 10-year maturities will be maintained.
- As part of the gradual restructuring of the bond program, issuance of the 30-year bonds will be reduced to a semi-annual basis. Last year, 3-year bonds were dropped from the program.
- As a consequence of the decrease in 30-year issuance, the proportion of 2-, 5- and 10-year bonds within the total bond program will be modestly higher than in 1997-98.

... 30-year bonds will be issued semi-annually.

Quarterly auction schedules will be retained.

- For the purposes of transparency, the bond auction calendar, containing dates for each bond maturity to be auctioned, will continue to be published prior to the start of each quarter.
- To maintain liquidity, the target benchmark sizes for all maturities will be maintained at \$7-10 billion.

The 2-year bond dating will be changed.

- The maturity dates for the 2-year bond will be changed to June 1 and December 1 (from March 15 and September 15) to enhance the fungibility of interest payments with the 10- and 30-year bonds, smooth out the bond maturity pattern and facilitate cash management.

Real Return Bonds (RRBs)

The target for RRBs continues to be modest growth.

The federal government plans to issue up to \$2 billion in RRBs in 1998-99. The currently planned method of distribution is quarterly single-price auctions.

Treasury Bills

The Treasury bill stock is expected to continue to decline in 1998-99.

The Treasury bill stock at the end of 1997-98 is expected to be in the area of \$113 billion, down from \$135 billion at the end of 1996-97.

Based on the fiscal plan for 1998-99, the Treasury bill stock is expected to fall roughly 10 per cent.

Retail Debt

Canada Investment and Savings (CI&S), the government's retail debt agency, plays an important part in the government's debt program, by targeting an investor base among the widest possible range of individual Canadians. Its long-term strategy is to continually develop innovative products and services that will fulfil investor needs and encourage Canadians to invest in Canada.

The retail debt plan for 1998-99 will be released directly by CI&S under separate cover.

Foreign Currency Debt Programs

The target level of foreign exchange reserves has been increased.

The Minister of Finance announced in the 1998 budget that, reflecting increased flows and volatility in foreign exchange markets, Canada's foreign exchange reserves would continue to be increased. This will bring Canada's reserves more in line with those of comparable countries.

The reserves are funded through a variety of instruments, including Canada Bills and Canada Notes, Global and Euro bonds, Euro Medium-Term Notes and cross-currency swaps of domestic obligations. The key determinants of the relative use of these instruments will be their contribution to minimizing the cost of carrying reserves and to maintaining a balanced maturity structure.

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Government
Publications

BUDGET 1999



*Building today for
a better tomorrow*

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Building Today for a Better Tomorrow

Overview

Effective management of the federal debt is important to all Canadians as the annual cost of servicing the debt currently takes about 27 cents of each dollar of revenue collected by the federal government.

In 1998-99, the government achieved its objective of prudently restructuring the debt stock by reducing the share of the federal debt that is maturing or repriced within a year. As a result, the government can better manage unexpected changes in interest rates – a 100-basis-point increase in interest rates today would raise public debt charges by \$0.9 billion in the first year, while in the mid-1990s, the first year impact of a 100-basis-point increase was estimated at about \$1.8 billion.

Based on results to date, over the fiscal years 1997-98 and 1998-99, a total of almost \$20 billion of market debt is expected to be retired. With a commitment to a balanced budget or better in each of the next two fiscal years, the stock of outstanding market debt is expected to continue to decline.

In this context, the debt strategy priority in 1999-2000 will be the maintenance of a well-functioning Government of Canada securities market, which provides low-cost financing for the government. Key initiatives in this regard include consultations on the possible restructuring of the Treasury bill program and the continuation of the pilot bond buyback program into 1999-2000.

The report is divided into the following sections:

- Debt Management Framework, outlining the objectives and key principles of the federal debt management strategy;
- Debt Management Environment, outlining the fiscal outlook over the next two years, and the impact on the debt structure and Government of Canada securities market;
- 1999-2000 Debt Management Strategy, highlighting overall debt strategy and providing an overview of initiatives for the next year; and
- 1999-2000 Federal Debt Programs, providing outlooks for each of the debt programs for 1999-2000.

The *Debt Management Strategy* is an annual publication of the Department of Finance. It provides information on the federal government's debt management strategy for the coming fiscal year.

The government's intention in issuing the *Debt Management Strategy* is to ensure the strategy remains transparent and well understood. It should be noted that the primary audience for this document is investors in Government of Canada securities and therefore the document is quite technical. A glossary is provided at the end of the document for other interested readers.

The government also publishes the *Debt Management Report* shortly after the release of the Public Accounts in the fall. Its focus is to report on the federal government's debt operations over the previous fiscal year, and to provide detailed information on the government's outstanding debt.

Debt Management Framework

This section outlines the federal government's objectives in managing the federal debt and the key principles underlying the pursuit of these objectives.

Debt management objectives

In the current environment of declining market debt, the task of debt management is to refinance maturing debt. In this context, the debt management objectives are to:

- provide stable, low-cost funding for the government; and
- maintain and enhance a well-functioning market for Government of Canada securities.

The fundamental debt management objective is to provide stable, low-cost funding for the government.

Domestic debt management

Principles

- Funding required for the government's domestic operations is raised in the domestic market.
- The government borrows on a regular, pre-announced basis.
- The government focuses on liquidity, transparency, regularity and market integrity in order to maintain a well-functioning market.
- Given the key role played by federal government securities in Canada's fixed-income market, adjustments to the domestic debt programs are made in consultation with market participants.

General strategy

- The debt stock is structured prudently to ensure reasonable cost stability under a range of potential interest rate environments. The target debt structure is not based on a particular interest rate outlook.
- Large benchmarks in Treasury bills and Government of Canada bonds are maintained to provide market liquidity.
- Bond benchmarks are built at the 2-, 5-, 10- and 30-year maturities, and a Real Return Bond benchmark is also maintained.
- The government maintains a broad investor base and active relations with investors and credit rating agencies.

Foreign currency debt management

Principles

- The government borrows in foreign currencies as required to fund Canada's foreign exchange reserves.

General strategy

- The government raises foreign exchange reserves through a range of programs, including short-term discount notes, medium-term notes, public bond issues and cross-currency swaps of domestic obligations. The liabilities are managed in conjunction with the assets to limit the cost of carrying reserves, and to maintain a prudent maturity structure.

Foreign currency debt is issued to raise foreign exchange reserves.

Another important measure is financial requirements/surplus. This measures the difference between cash coming into the government and cash payments made for programs and public debt charges during the year. Canada recorded a financial surplus of \$1.3 billion in 1996-97, \$12.7 billion in 1997-98, and on the basis of the current budget plan, is expected to record a surplus of \$11.5 billion in 1998-99.

Within the G-7, Canada was the first country to record a financial surplus in this decade.

Financial requirements/surplus are broadly comparable to the measures of the budgetary balance used by other major industrialized countries, including the United States. Within the G-7, Canada was the first country to record a financial surplus in this decade and only Canada and the United States are expected to continue to record financial surpluses over the near term.

The federal government is expected to continue reducing its market debt.

Financial requirements/surplus provide a broad indication of the change in market debt actually outstanding and held by investors. In 1997-98, the government retired \$9.6 billion of market debt, and based on results to the end of December 1998, is expected to retire a similar amount in 1998-99, for a cumulative total of about \$20 billion over the two years. With a commitment to a balanced budget or better in each of the next two years, which will result in financial surpluses, the stock of outstanding market debt is expected to continue to decline. However, the actual decline will depend not only on the government's financial surplus but also on foreign exchange transactions and changes in the government's cash balances. As a result, market debt programs will need to be gradually restructured.

Changing debt structure and holdings

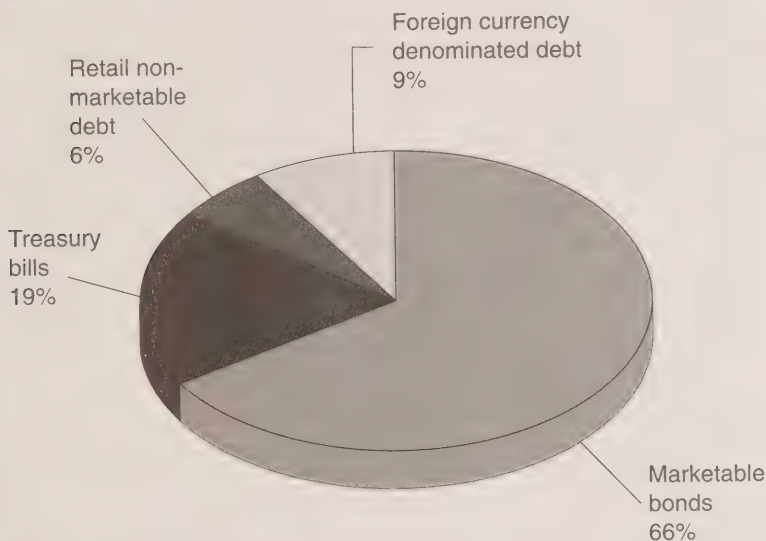
In order to reduce exposure to unexpected changes in interest rates, the federal government has increased the portion of the debt in fixed-rate form¹ from 53 per cent, in 1993-94, to two-thirds in 1998-99. The federal government is committed to maintaining a prudent debt structure.

The federal government's market debt is made up of four major components: marketable bonds, Treasury bills, retail non-marketable debt (primarily Canada Savings Bonds) and foreign

¹ The fixed-rate share of the debt is the percentage of the gross debt that matures or is being repriced in more than 12 months. The target for the fixed-rate share of the debt is based on gross debt, which includes market debt and non-market debt. However, debt management activities focus on market debt only (see glossary for further information).

currency denominated debt. In recent years, the composition of the federal government's market debt has undergone significant changes, with the share held in short-term instruments, primarily Treasury bills, declining, while the share held in longer-term instruments has increased. However, the composition of market debt is expected to remain largely the same over the next few years. The following chart shows the forecast composition of market debt for March 31, 1999.

Forecast composition of federal market debt
March 31, 1999¹



¹Excluding bonds issued to the Canada Pension Plan.

Federal government debt is held by a wide range of institutional and retail investors. Of note is the fact that non-resident holdings of Government of Canada debt have been steadily declining in the last few years, from a peak of 28 per cent of total market debt in 1993 to less than 25 per cent today.

Government of Canada securities market

A well-functioning Government of Canada securities market provides low-cost financing for the government. It is also of general benefit to the domestic capital market, where benchmark federal securities are key investments. Because these securities are actively traded, they act as pricing and hedging tools in the fixed-income market.

The maintenance of a well-functioning Government of Canada securities market remains a high priority for the federal government.

The government will continue to pursue the principles of liquidity, transparency and regularity.

Liquidity,² transparency, and regularity are the principles underlying the maintenance of a well-functioning market. Borrowing in the domestic market on a regular, pre-announced basis and building bond benchmarks, for instance, reflects these principles (further details of the 1999-2000 debt program plans are provided in a later section of this report).

As market debt declines, a high priority for the federal government is maintaining the attractiveness of the Government of Canada market to investors. The objective is to ensure that the Government of Canada securities market continues to be one of the most liquid and efficient sovereign markets in the world, featuring tight bid-offer spreads, large transaction volumes and high turnover ratios.

The federal government supports the development of all aspects of a well-functioning market.

Initiatives taken in 1998-99 to ensure a well-functioning market include changes to the government's auction rules and the development of an Investment Dealers Association (IDA) Code of Conduct. The modified auction rules reinforce the integrity of the auction process for Government of Canada securities, and encourage participation in auctions by reducing the potential for manipulative behaviour prior to and during auctions. The IDA Code of Conduct, which is actively supported by the federal government and the Bank of Canada, establishes standards for the trading of debt securities in the secondary market.³

The federal government will continue to promote the development of the futures market for Government of Canada securities. The federal government's and the Bank of Canada's work with the Montreal Exchange and the investment community has contributed to the development of the highly successful futures contract based on 3-month bankers' acceptance rates (the BAX contract) and active 10- and 5-year Government of Canada bond futures contracts (the CGB and CGF contracts).

The federal government and the Bank of Canada continue to support the development of a screen-based information system on prices and trades in the secondary market in Government of Canada securities. The system would help improve market price transparency in the secondary market.

² A liquid market is a market with good trading volumes, where trades of medium and even large sizes can be effected quickly without materially affecting the price.

³ This initiative is directly linked to the auctions of Government of Canada securities through the new terms of participation in auctions for government securities distributors and customers.

1999-2000 Debt Management Strategy

Providing stable low-cost financing – maintaining a prudent debt structure and diversified investor base

While market debt is being reduced, the stock nonetheless remains large. Canada's debt stock is exposed to interest rate changes originating in Canada and around the world. Interest rate shocks can significantly affect the level of annual debt charges, as the portion of debt that is rolling over must be issued at the new prevailing market interest rates. Some \$216 billion of the federal market debt will be maturing or repriced over the 1999-2000 fiscal year.

Maintaining a prudent debt structure is essential in protecting the government's fiscal position from unexpected increases in interest rates, as well as moderating refinancing risk. A prudent debt structure is one that provides reasonable cost stability under a range of economic scenarios. Such a structure also maintains investor and credit rating agency confidence.

The federal government's target of two-thirds for the fixed-rate share of the debt, set at the beginning of the 1998-99 fiscal year, has been achieved. This means that a 100-basis-point increase in interest rates would now raise public debt charges by \$0.9 billion in the first year; in the mid-1990s, the first-year impact of a 100-basis-point increase was estimated at about \$1.8 billion. As a result, the government can better manage unexpected changes in interest rates.

The federal government is committed to maintaining a prudent debt structure by keeping the target fixed-rate share of the debt at two-thirds. Fluctuations in the ratio will periodically occur due to operational considerations such as large maturing benchmarks.

A diversified investor base ensures that funding costs are kept low. The federal government pursues diversification of its investor base through the maintenance of a liquid and transparent domestic debt program, and internationally through the use of a broad array of sources of funds. In addition, Canada Investment and Savings, the government's retail debt agency, provides diversification by offering savings products designed to suit the needs of individual Canadians.

The government is committed to maintaining a prudent debt structure.

The fixed-rate target of two-thirds of the debt has been achieved.

A diversified investor base is maintained to ensure funding costs are kept low.

Maintaining and enhancing a well-functioning market

Debt program design

Gradual adjustments to the debt programs will be made in consultation with market participants.

To maintain transparency and regularity in its debt operations, the government will continue to borrow in the domestic market on a regular, pre-announced basis. This approach ensures market awareness of future debt operations, attracts a wide range of investors, and promotes liquidity. In 1999-2000, the government will continue to hold regularly scheduled quarterly auctions of 2-, 5- and 10-year bonds, and semi-annual auctions for the 30-year bonds. Quarterly auctions of Real Return Bonds will also be held.

The pilot bond buyback program will be extended into 1999-2000.

To enhance liquidity in Government of Canada bonds, a pilot bond buyback program was implemented in 1998-99. The purpose of this program is to buy back existing less liquid bonds to support the maintenance of a liquid new bond issue market. By buying back less liquid bonds, the government's ability to maintain its strategy of building large benchmark bonds at key maturities is facilitated.

The pilot phase for the program will be extended into 1999-2000. The bond program for 1999-2000 has been designed incorporating buyback activity. Buyback transactions will occur in conjunction with selected bond auctions and will be announced with the auction size.

The Treasury bill program had to be adjusted significantly as the debt structure moved to a fixed ratio of two-thirds and following the success of the government in achieving financial surpluses. Treasury bill stock has declined from \$166 billion at the end of fiscal year 1995-96 to \$87 billion in December 1998. However, the impact of this decline on money market liquidity has been mitigated by growth in the bankers' acceptance (BA), commercial paper (CP), forward rate agreements (FRA) markets, and by the existence of a liquid bankers' acceptance futures contract (BAX).

A possible Treasury bill program restructuring is under review.

In order to enhance liquidity in the Treasury bill market, the federal government changed the Treasury bill issuance to a bi-weekly pattern (from weekly) in the fall of 1997. In the fall of 1998, in expectation of a gradual continuing decline in the Treasury bill program size, the government commenced consultations with market participants regarding possible options for further Treasury bill program restructuring. These consultations are ongoing, and the government will announce its plans later in 1999.

The government also proposes to update the *Financial Administration Act* (FAA) through the 1999 budget legislation. The relevant sections of the FAA, which date back to the 1950s, need to be amended to modernize the federal government's debt and risk management capabilities, and clarify borrowing authority and the authority for setting the terms of distribution of federal government securities.

Amendments will be proposed to the debt management provisions of the *Financial Administration Act*.

Looking further ahead, the government's plan is to adjust domestic debt programs over time to maintain liquidity in the Government of Canada securities market. The government will be proceeding on a gradual basis, in close consultation with market participants.

Foreign currency borrowing has become a more significant element of debt operations, reflecting the government's announcement in the 1996 and 1998 budgets of its intention to raise the level of reserves, and the increased intervention activity in the foreign exchange market in 1998. There is an active array of funding programs, including Canada bills and Canada notes, Global and Euro bonds, and Euro Medium-Term Notes.

Foreign debt operations will be driven by foreign exchange reserve needs.

Enhancing market integrity

The federal government and the Bank of Canada have been working closely with market participants on a number of initiatives to enhance market integrity.

In 1999-2000, the federal government and the Bank of Canada will be promoting adoption by institutional investors of a code of conduct similar to the one adopted by the Investment Dealers Association.

A number of initiatives will be pursued to ensure the integrity of the Government of Canada securities market is maintained.

The proposed amendments to the FAA to clarify the government's authority for setting the terms of distribution of federal government securities are consistent with the changes in the auction rules made in 1998-99, which were directed at enhancing market integrity in the Government of Canada securities market.

The federal government and the Bank of Canada will also continue to support improved secondary market price transparency.

A note on the year 2000 issue

Since the last months of debt management operations for fiscal year 1999-2000 will take place in the new millennium, the potential impacts of the Year 2000 (Y2K) issue on debt operations have been carefully reviewed by the federal debt managers.

The Bank of Canada is responsible for providing fiscal agency services for the federal government. The Bank began planning for the year 2000 in October 1996. In April 1997, an internal Y2K impact assessment was completed by the Bank, which indicated that its systems will be fully Y2K ready.

1999-2000 Federal Debt Programs

The federal debt management strategy for each debt program is presented below. These plans are based on the 1999 budget outlook for financial surpluses (excluding foreign exchange transactions). The forecast is \$5.0 billion for 1999-2000, and \$7.0 billion for 2000-01.

Plans for market debt programs are based on the 1999 budget outlook.

The strategy has been developed in consultation with market participants. The federal government will continue to consult with market participants in fiscal year 1999-2000 on potential adjustments to maintain a well-functioning market in the changing debt management environment.

The federal government uses a variety of instruments to fund its domestic operations:

- Fixed-rate marketable bonds
- Real Return Bonds (RRBs)
- Treasury bills
- Retail non-marketable debt (primarily Canada Savings Bonds)

The foreign currency borrowing program is used to fund Canada's foreign exchange reserves.

The following table shows the composition of the government's market debt.

Composition of federal market debt¹

	March 31, 1998	December 31, 1998
	(billions of C\$)	
Fixed-rate marketable bonds	284.7	289.0
RRBs	9.9	11.1 ²
Treasury bills	112.3	87.1
Retail non-marketable debt	29.8	27.6
Foreign currency denominated debt	27.2	36.1
Total	463.8	450.9

Note: May not add due to rounding.

¹ March 1998 numbers are from the Public Accounts. December 1998 numbers are based on the Fiscal Monitor. Bonds issued to the Canada Pension Plan are not included.

² RRB numbers for December 1998 do not include consumer price index adjustment so far this fiscal year.

Fixed-rate marketable bonds

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. In 1999-2000, about \$45 billion of bonds will be maturing.

1999-2000 program

The planned bond program for 1999-2000 will be about \$36 billion in total, incorporating plans to continue the pilot bond buyback program.

- The 1999-2000 bond program (i.e. gross issuance), which takes into account buyback operations, is planned to remain at a level similar to the 1998-99 program, which will be about \$36 billion in total.
- Regular, quarterly issuance of the 2-, 5- and 10-year maturities and semi-annual issuance of the 30-year maturity will be maintained.
- The bond auction calendar, containing dates for each bond maturity to be auctioned, will continue to be published prior to the start of each quarter.
- To maintain liquidity, the target benchmark sizes for all maturities will be maintained at \$7-10 billion.
- Buyback operations on a pilot basis will continue on selected bonds and auctions.

Real Return Bonds (RRBs)

The federal government plans to issue up to \$2 billion in RRBs in 1999-2000, building a new benchmark. The maturity of the new benchmark will be announced later in 1999.

The target for Real Return Bonds continues to be modest growth.

Treasury bills

Based on the fiscal plan in the budget, the Treasury bill stock in 1999-2000 is expected to fall by about 5 per cent, less sharply than in recent years. However, due to swings in the government's cash needs, the decline will be greater in certain periods during the year.

The Treasury bill program structure is under review given its continuing gradual decline.

As noted earlier, in order to offset declining liquidity in the Treasury bill market, the government has commenced consultations with market participants on the program structure. Various options are under consideration, ranging from maintaining the status quo to changes to the frequency of issuance and changes in tranche structure. Consultations are ongoing and further details of the government's plans will be announced later in 1999.

Retail debt

Canada Investment and Savings (CI&S), the government's retail debt agency, plays an important part in the government's debt program, by targeting an investor base among the widest possible range of individual Canadians. Its long-term strategy is to provide products and services that will fulfil investor needs and encourage Canadians to invest in Canada.

Retail debt is an important part of the government's debt program.

The retail debt plan will be released by CI&S later in 1999.

Foreign currency debt programs

Principal sources of funding for the exchange reserves will depend on market conditions, but are expected to include medium-term note issuance in various markets, cross-currency swaps of domestic obligations, outright purchases of U.S. dollars and occasional large international bond issues. Key considerations underlying the choice of funding instruments are asset and liability management, minimization of cost and maintenance of a prudent maturity structure.

Foreign funding activity will be spread across a range of funding sources.

Glossary

bankers' acceptance (BA): Short-term negotiable commercial paper issued by a non-financial corporation but guaranteed by a bank.

BAX: See Futures contract.

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

bid: Price a buyer is ready to pay. The bid-offer spread is the difference between bid and offer prices.

budgetary surplus: Occurs when government annual revenues exceed budgetary expenditures. A **deficit** is the shortfall between government revenues and budgetary spending.

Canada bills: Canada bills are promissory notes denominated in U.S. dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada notes: Canada notes are promissory notes usually denominated in U.S. dollars and available in book-entry form. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserve funding purposes only.

Canada Savings Bonds (CSBs): Currently offered for sale by most Canadian financial institutions to individual Canadians. CSBs pay a competitive rate of interest which is guaranteed for one or more years. They may be cashed at any time and, after the first three months, pay interest up to the end of the month prior to encashment.

CGB: See Futures contract.

CGF: See Futures contract.

commercial paper: Short-term debt securities issued by non-financial corporations.

Contingency Reserve: The Contingency Reserve is included in the budget projections primarily to cover risks arising from: (i) unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and (ii) unpredictable events. The Contingency Reserve also provides an extra measure of back-up against adverse errors in the economic forecast. The Contingency Reserve is not a source of funding for new policy initiatives.

coupon: The interest rate specified on a bond when it is originally issued.

discount notes: Short-term debt securities where the yield is provided through a discounted selling price relative to the face value of the note.

Euro Medium-Term Notes (EMTNs): Medium-term notes issued outside the United States and Canada. EMTNs are issued for foreign exchange reserve funding purposes only.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar on the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

financial requirements/surplus (excluding foreign exchange transactions): Measures the difference between the cash received by the government and cash payments made. In the case of a financial requirement, it is therefore the amount of new borrowing required from outside lenders to meet the government's financing needs in any given year.

fixed-coupon marketable bond: A market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than twelve months.

foreign exchange reserves: Stocks of foreign exchange assets (e.g., interest earning bonds) held by sovereign states to support the value of the domestic currency. Canada's foreign exchange reserves are held in a special account called the Exchange Fund Account.

forward rate agreement (FRA): Short-term interest rate guarantee instruments that are negotiated by two parties, one of which is typically a chartered bank.

futures contract: Agreement to buy or sell a financial instrument at a particular price, for a specific quantity, on a stipulated future date. Fixed-income futures contracts are traded in the futures market at the Montreal Stock Exchange. The key fixed-income futures contracts are the 5- and 10-year Government of Canada bond futures contracts (the CGF and the CGB contracts) and the bankers' acceptance contracts (BAX).

gross public debt: Total amount the government owes. It consists both of market debt in the form of outstanding securities such as Treasury bills and Canada Savings Bonds, and internal debt owed mainly to the superannuation fund for government employees and other current liabilities.

hedge: A transaction intended to reduce the risk of loss from price fluctuations.

interest bearing debt: Consists of unmatured debt, or market debt, and the government's liabilities to internally held accounts such as federal employees' pension plans.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets and includes marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds) and foreign currency denominated bonds and bills.

market transparency: Within the context of debt management, characterization of a bond market where debt management strategies and operations are visible and well understood by market participants.

net public debt: Consists of interest bearing debt and other liabilities, net of financial assets.

non-market debt: Includes the government's internal debt which is for the most part federal public sector pension liabilities, the government's current liabilities (such as accounts payable, accrued liabilities, interest and payment of matured debt), and bonds issued to the Canada Pension Plan.

primary market: Market for new issues of securities.

Real Return Bonds (RRBs): Government of Canada RRBs pay semi-annual interest based upon a real interest rate. Unlike standard fixed-coupon marketable bonds, interest payments on RRBs are adjusted for changes in the consumer price index.

secondary market: Market where securities are bought and sold subsequent to original issuance.

sovereign market: Market for the debt issued by a government.

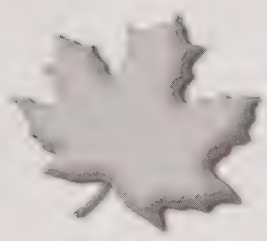
swap: An agreement that exchanges one type of return for another (e.g., a fixed for a floating rate of interest).

tranche: A portion of a bond offering, delineated by maturity.

Treasury bills: Treasury bills are short-term obligations, sold by public tender. Treasury bills with terms to maturity of three, six, or twelve months are currently auctioned on a bi-weekly basis.

turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

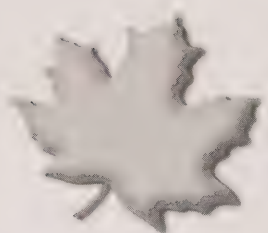
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DEBT MANAGEMENT STRATEGY

2000-01





DEBT MANAGEMENT STRATEGY

2000-01



Department of Finance
Canada

Ministère des Finances
Canada

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Foreword by the Minister of Finance

I am pleased to table for the first time before Parliament the *Debt Management Strategy* of the Government of Canada for fiscal year 2000-01. Previously, the *Debt Management Strategy* was released only as an annual publication of the Department of Finance Canada.

Effective management of the federal debt is important to all Canadians as the cost of servicing the debt currently takes about 26 cents of each dollar of revenue collected by the federal government, down from 33 cents when this government took office.

Fulfilling its ongoing commitment to sound financial management, the Government expects to report a balanced budget or better in 1999-2000. In addition, the Government committed in the 2000 budget to maintain balanced budgets or better in 2000-01 and 2001-02. This will mean five consecutive years of balanced budgets or surpluses, a performance not matched in the last 50 years. As a result, the debt-to-GDP ratio, a measure of the debt against the size of our economy, will continue to fall. This is important because the lower the ratio, the more manageable the public debt.

That being said, the level of debt remains significant. It is thus important to ensure that debt servicing costs are kept low and stable. Key elements of the debt strategy to that end are maintaining a prudent debt structure and ensuring a well-functioning market for Government of Canada securities.

The *Debt Management Strategy* provides comprehensive information on the federal government's debt management strategy for the coming fiscal year. The Government's intention in tabling this document is to ensure parliamentarians, market participants and indeed all Canadians are aware of the strategy and the results it is intended to achieve.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, March 23, 2000

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Debt Management Framework

This section outlines the federal government's objectives in managing the federal debt and the key principles underlying the pursuit of these objectives. (To assist readers who are unfamiliar with the technical terminology of debt management, a glossary is provided at the end of this document.)

Debt Management Objectives

With the Government's commitment to balanced budgets or better, the current focus of debt management is to refinance maturing debt.

- The fundamental objective of debt management continues to be to provide stable, low-cost funding for the Government.
- A related important objective is to maintain a well-functioning market for Government of Canada securities.

The fundamental debt management objective is to provide stable, low-cost funding for the Government.

Domestic Debt Management

Principles

- Consistent with the practice of many sovereigns, funding for the Government's domestic financial requirements is raised in the domestic market in Canadian dollars.
- In order to maintain a well-functioning domestic market and keep borrowing costs low, the Government focuses on the key aspects of transparency, liquidity and regularity. For this reason, the Government borrows in the market on a regular, pre-announced basis and builds large bond benchmarks.
- Given the key role played by federal government securities in Canada's fixed-income market, market participants are consulted extensively on the Government's debt strategy and adjustments to its domestic debt programs.

General Strategy

- The primary focus of the Government's debt management strategy is the structure of the debt, as the exposure to changes in interest rates inherent in the maturity profile of the debt stock can impact debt servicing costs. The Government structures the debt prudently to provide reasonable cost stability under a range of potential interest rate environments and a moderate level of regular financing operations. The target debt structure is not based on a particular interest rate outlook.
- Large benchmarks in Treasury bills and Government of Canada bonds are maintained to promote market liquidity.
- Bond benchmarks are built at the 2-, 5-, 10- and 30-year maturities, and a Real Return Bond benchmark is also maintained.
- The Government maintains a diversified investor base and active relations with investors and credit rating agencies.

Foreign Currency Debt Management

Principles

Borrowings in foreign currencies fund Canada's foreign exchange reserves.

Foreign currency borrowings by the Government fund Canada's foreign exchange reserves.

Major risks, including currency and interest rate risk, are largely immunized by investing borrowings in matching assets of high credit quality.

General Strategy

The Government finances foreign exchange reserves through a range of programs, the use of which is determined by asset portfolio objectives, cost, maturity profile and market conditions.

In general, there is a modest cost to holding reserves, as the yield on high quality assets is less than the cost of funding. Liabilities are managed in conjunction with the reserve assets to limit the cost of holding reserves and to maintain a prudent maturity structure to limit refinancing needs.

The Government's foreign exchange reserves are held predominantly in US dollars, supplemented by euro- and yen-denominated reserves.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government is committed to a balanced budget or better based on prudent planning assumptions.

The Government's fiscal policy sets the context for debt management operations. Fulfilling its ongoing commitment to maintain sound financial management, the Government expects to report a balanced budget or better in 1999-2000. The Government will continue to follow a prudent approach to budget planning, backed by a \$3-billion Contingency Reserve and economic prudence, and has committed to maintain balanced budgets or better in 2000-01 and 2001-02. This will mean five consecutive years of balanced budgets or surpluses – a performance not matched in the last 50 years.

The public debt burden is expected to decline over time.

Given the outlook for balanced budgets, over the next two years the stock of public debt is expected to remain unchanged at its 1998-99 level. However, this projection does not take into account the Contingency Reserve. Consistent with the Debt Repayment Plan, the Government will continue to use the Reserve to reduce the public debt in those years when it is not required. The Plan and sustained economic growth will ensure that the debt-to-GDP (gross domestic product) ratio – the level of debt in relation to the country's annual income – remains on a permanent downward track. From a peak of 71.2 per cent in 1995-96, the debt-to-GDP ratio is expected to fall to about 55 per cent by 2001-02 and to below 50 per cent in 2004-05. Lowering the debt-to-GDP ratio remains a key objective of the Government's fiscal policy.

The Debt Repayment Plan

The prudent approach to budget planning contained in the Government's Debt Repayment Plan will continue. This entails:

- continuing to use the average of private sector economic forecasts for budget planning purposes;
- continuing the practice of setting aside an annual \$3-billion Contingency Reserve which, if not needed, will be used to pay down the public debt; and
- continuing to add an extra degree of economic prudence to provide further assurance against falling back into a deficit.

Financial Balance

The key budgetary measure for debt management planning is the financial balance (see the box on the next page). In general, balanced budgets can be expected to reduce market debt (see page 12 for a description of market debt) as they are normally accompanied by financial surpluses. However, the precise relationship between the budgetary balance and financial balance will vary from year to year, as it depends in part on the level of a number of non-budgetary transactions. It also depends on the timing of cash payments – cash payments may be made in one year for liabilities incurred in a different year.

The Government is projecting a financial surplus of \$8.0 billion for 1999-2000, while a financial requirement of \$5.0 billion is projected for 2000-01. The change from financial surplus to requirement reflects a number of factors, including public sector pension reform and several extraordinary cash payments that will also arise in 2000-01. Of note, the reforms to public sector pension plans will permanently reduce the difference between the budgetary balance and financial balance. With the ending of the special payments, a financial balance is projected for 2001-02.

A number of extraordinary cash payments and public sector pension reform will give rise to a financial requirement in 2000-01.

The primary reason the Government is forecasting a financial requirement in an environment of a balanced budget is that there will be a number of extraordinary cash payments in 2000-01, the liabilities for which were included in the budgetary balance in prior fiscal years. These include payments associated with the pay equity settlement and the Canada Health and Social Transfer cash supplement to a third-party trust.

In addition, the reform of public sector pension plans becomes effective April 1, 2000. Under this reform, government and employee contributions to the pension plans will be invested in financial markets rather than included as part of non-budgetary transactions. This will reduce the non-budgetary source of funds by at least \$3.5 billion per year. As well, a number of Crown corporations, which are currently members of the public sector pension plan, will be establishing their own pension plans and will receive in cash over the next two fiscal years the accrued value of their share of the plan.

The Budgetary Balance and Financial Balance

The budgetary balance – deficit/surplus – is one measure of the Government's financial situation. It is largely presented on an accrual basis of accounting in that it includes liabilities incurred by the Government regardless of when the actual cash payment is made.

The financial balance – requirements/surplus – provides a measure of the net cash requirements needed to fund the Government's programs and debt charges during the year. The difference between the financial balance and the budgetary balance is due to a number of non-budgetary transactions that provide funds to the Government. Non-budgetary transactions convert the accrual-based concepts in the budgetary balance to cash-based financial requirements. The largest of the non-budgetary transactions are the government employee pension accounts.

Excluding foreign exchange requirements, the federal government recorded a financial surplus in each of the last three years – \$1.3 billion in 1996-97, \$12.7 billion in 1997-98 and \$11.5 billion in 1998-99.

The net financial balance includes foreign exchange transactions, which represent all transactions in international reserves held in the Exchange Fund Account. Including these transactions, the Government recorded a net financial requirement of \$6.5 billion in 1996-97, and a surplus in each of the two following years – \$10.6 billion in 1997-98 and \$5.8 billion in 1998-99.

The Government ensures that it holds a prudent level of foreign exchange reserves.

Foreign Exchange Transactions

The Government's net financial balance is the domestic financial balance less foreign exchange transactions.

In recent years, the Government's commitment to raise the level of international reserves, announced in the 1996 and 1998 budgets, as well as increased intervention activity in the foreign exchange market, particularly in 1998, has meant that foreign exchange transactions have become a somewhat larger, although still modest, element of debt operations. These activities have resulted in a reduction in the financial surplus. However, to the extent that they increase Canada's foreign exchange reserves, these transactions do not change the level of the net public debt. Foreign reserves are assets of the Government, thus offsetting foreign exchange liabilities.

No additional market borrowing is expected to be required in 2000-01.

Market Debt Impact

A total of \$16.4 billion in market debt was retired in 1997-98 and 1998-99. Additional market debt retirement is projected for 1999-2000, bringing total debt retirement over this three-year period to around \$20 billion. While market debt is generally on a downward track, it is expected to remain largely unchanged in 2000-01 due to the public sector pension reform and extraordinary cash payments. The projected financial requirement of \$5 billion in 2000-01 is expected to be met without additional borrowing. Strong financial results in 1999-2000 have allowed the Government to position itself to meet the large expenditures in 2000-01 by increasing domestic cash balances. If necessary, the Government can draw on the existing amount of \$4 billion in non-lapsing borrowing authority.

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained to raise new debt, in the form of a borrowing authority bill.

Currently, available borrowing authority is limited to a \$4-billion non-lapsing contingency under the 1996-97 Borrowing Authority Act.

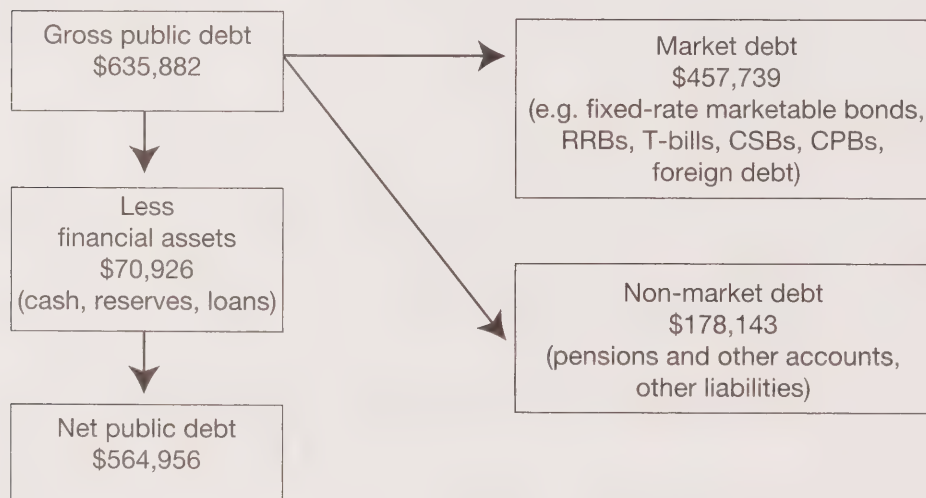
Debt Structure and Holdings

Debt management operations focus primarily on market debt, which is only one component of the total public debt. The other component – non-market debt – is taken into account in debt strategy planning, but is not actively managed. Non-market debt includes federal public sector pension liabilities and the Government's current liabilities.

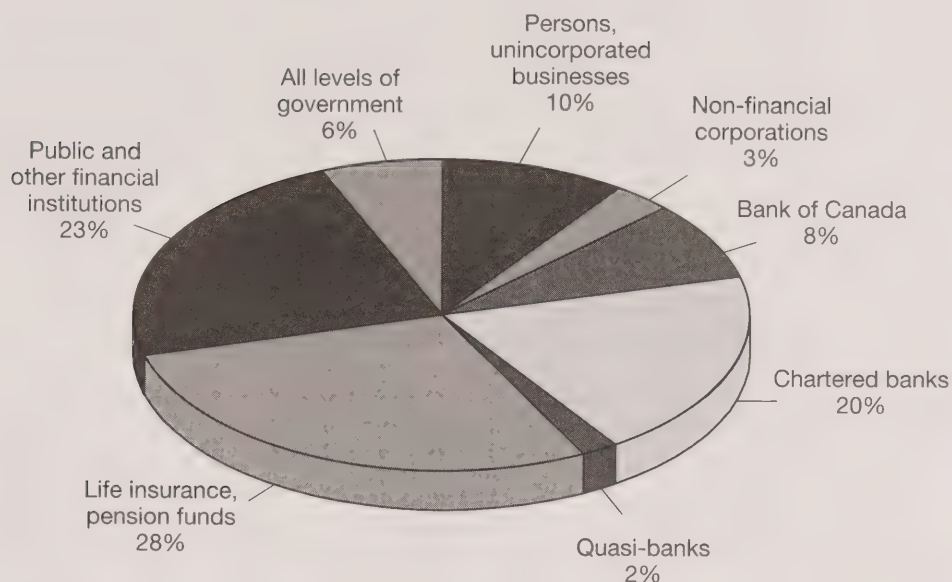
The federal government's market debt consists mainly of fixed-rate marketable bonds, Real Return Bonds (RRBs), Treasury bills (T-bills), retail non-marketable debt (Canada Savings Bonds [CSBs] and Canada Premium Bonds [CPBs]) and foreign currency denominated debt. The composition of the federal government's market debt has remained relatively stable in recent years, following a period of significant change in the mid-1990's, when the share of market debt held in short-term instruments (e.g. T-bills) declined and the share held in longer-term instruments (e.g. fixed-rate marketable bonds) increased.

The chart below illustrates the relationships between the components of public debt.

Total Public Debt as at January 31, 2000
(in millions of dollars)



Distribution of Domestic Holdings of Government of Canada Market Debt¹



Source: Statistics Canada, *National Balance Sheet Accounts* – 1998.

¹ Includes investment dealers, mutual funds, fire and casualty insurance companies, sales, finance and consumer loan companies, accident and sickness branches of life insurance companies, other private financial institutions (not included elsewhere), federal public financial institutions, and provincial financial institutions.

A wide range of institutional and retail investors hold federal government debt. Non-resident holdings of Government of Canada debt have been declining in the last few years, decreasing from a peak of 28 per cent of total market debt in 1993 to around 23 per cent today. The decline was notable in 1999 in the prevailing financial surplus environment.

2000-01 Debt Management Strategy

Raise Stable, Low-Cost Financing

Maintaining a Prudent Debt Structure

While the Government's fiscal position has improved considerably in recent years with the elimination of the deficit, the stock of outstanding debt remains large. Moreover, Canada's debt stock is exposed to interest rate changes originating in Canada and around the world. Interest rate shocks can significantly affect the level of annual debt charges, as the portion of debt that is rolling over must be issued at the new prevailing market interest rates. Some \$248 billion in federal market debt will be maturing or repriced over the 2000-01 fiscal year.

Determining the Debt Structure Target

Given the large stock of outstanding debt, the Government's debt strategy aims to strike a balance between keeping debt service costs low and stable over time, while ensuring that a well-functioning market for Government of Canada securities is maintained. A prudent debt structure is maintained to limit exposure to unexpected changes in interest rates and ongoing refinancing requirements, which serves to maintain investor and credit rating agency confidence.

The Government has put in place a prudent debt structure by altering the term structure of its debt, specifically by issuing more long-term debt and less short-term debt. While there are a number of indicators that can be used to assess the debt structure, the Government's chosen target is the share of interest-bearing debt issued at fixed rates (i.e. maturing or repricing beyond one year). Thus, greater stability of debt servicing costs has been achieved over the past several years by increasing the share issued at fixed rates from about 50 per cent in 1992-93 to about two-thirds in 1998-99, where it currently stands, bringing the term structure of the debt in line with other major sovereign borrowers.

The debt structure target is reviewed annually. For 2000-01, the target fixed-rate share of the debt will be maintained at two-thirds.

As part of debt strategy planning, the debt structure target is reviewed annually to assess its ongoing suitability given changes in the fiscal and economic environment, and to ensure that it remains consistent with the best practices of other sovereign borrowers. For 2000-01, the target fixed-rate share of the debt will remain at two-thirds. A discussion of the costs and benefits of the target debt structure is provided in the box on the next page.

Implications of the Target Debt Rate Structure

One benefit of increasing the fixed-rate share of the debt to two-thirds is that it ensures that the debt stock is less sensitive to changes in interest rates. A 100-basis-point increase in interest rates would now raise public debt charges by \$0.9 billion in the first year; in the mid-1990s, when 57 per cent of the debt was at fixed rates, the first-year impact of a 100-basis-point increase in interest rates was estimated at about \$1.8 billion.

The long-term costs of maintaining a prudent debt structure are impossible to predict, since interest rates will change significantly over time due to both internal and external developments. Using current interest rates, maintaining a higher fixed-rate share of debt gives rise to increased debt service costs for the Government since short-term funds are currently cheaper than long-term funds. By way of illustration, debt servicing costs would differ by \$110 million next year with a 5-percentage-point difference in the debt structure. In other words, given the forecast for interest rates contained in the budget and the current maturity profile of various types of government debt, the cost of a 5-per-cent higher fixed stock (72 per cent) would be \$110 million more next fiscal year than the two-thirds target structure, while a 5-per-cent lower fixed stock (62 per cent) would result in a reduction of debt costs of \$110 million over the next fiscal year.

Under a worst-case scenario of significantly higher interest rates that continue for some time, debt service costs under the current structure would be less affected than under a higher floating-rate structure. In order to limit the potential impact of such a scenario on the fiscal plan, the Government has adopted a more prudent structure, similar to that maintained by other comparable sovereigns.

The Government continuously improves the quality of its debt strategy modelling and uses a variety of planning tools. Among them is sophisticated cost sensitivity analysis of the target debt structure, which demonstrates that there are particular benefits to a two-thirds fixed-rate target debt structure. The analysis of a wide distribution of future interest rate scenarios indicates that, under the two-thirds structure, unexpected changes in interest rates over a five-year horizon should not disrupt the fiscal plan. Specifically, the analysis indicates that the two-thirds fixed-rate structure is highly likely to limit the fiscal impact of interest rate shocks to less than the \$3-billion Contingency Reserve.

A further benefit of maintaining the fixed debt structure at two-thirds is that it ensures that regular access to markets via Treasury bills is kept at a reasonable level. In 1995, when the fixed-rate share of the debt was at 55 per cent, the Government was required to refinance, on average, \$8 billion per week in maturing Treasury bills. Today, the Government only needs to refinance \$4 billion per week. At the same time, the one-third share of floating-rate debt helps to keep debt servicing costs low, provided short-term rates remain lower than long-term rates.

A diversified investor base is maintained to ensure funding costs are kept low.

Maintaining a Diversified Investor Base

Maintaining a diversified investor base is also an important factor in ensuring that funding costs are kept low. The federal government pursues diversification of its investor base through the maintenance of a liquid and transparent domestic wholesale debt program and internationally through the use of a broad array of sources of funds. In addition, Canada Investment and Savings, the Government's retail debt agency, contributes to the maintenance of a diversified investor base by offering savings products designed to suit the needs of a large number of individual Canadians.

Maintaining a well-functioning Government of Canada securities market remains a high priority for the federal government.

Maintain and Enhance a Well-Functioning Market

Maintaining a well-functioning Government of Canada securities market, by focusing on the key aspects of liquidity, transparency and regularity, remains a high priority for the federal government in the general environment of declining market debt. A well-functioning Government of Canada securities market provides low-cost financing for the Government by promoting broader participation in the market. It is also of general benefit to the domestic capital market, where benchmark federal securities are key investments; because they are actively traded, these securities act as pricing and hedging tools in the fixed-income market.

The Government will continue to maintain the principles of liquidity, transparency and regularity in its debt programs.

The federal government actively pursues initiatives designed to ensure that the quality and integrity of the Government of Canada securities market is maintained, and that the market continues to be one of the most liquid and efficient sovereign markets in the world, featuring tight bid-offer spreads, large transaction volumes and high turnover ratios.

The federal government pursued a number of initiatives in 1999-2000, including:

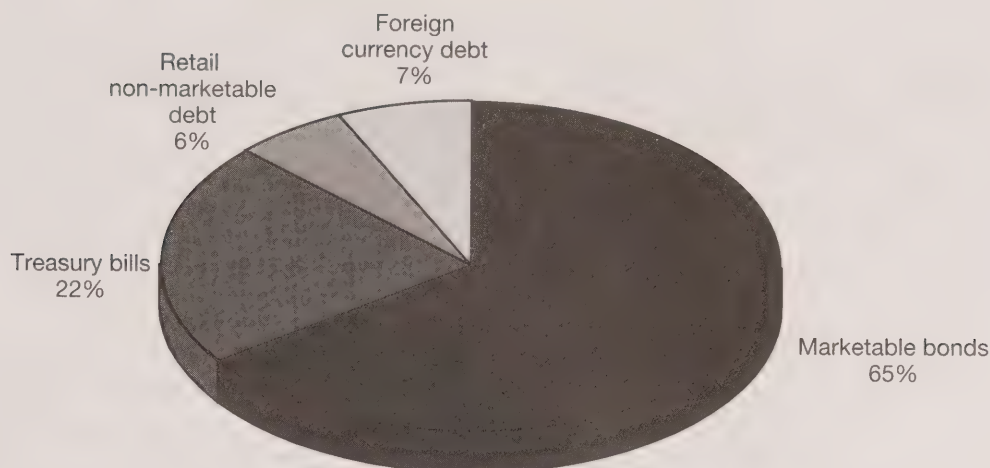
- reviewing the structure of the Treasury bill program to ensure it continues to function well;
- continuing the pilot buyback program to support the maintenance of a liquid new bond issue market;
- changing the Financial Administration Act to modernize the federal government's risk and debt management capabilities; and
- supporting the development of improved secondary market price transparency.

2000-01 Debt Program Initiatives

Outlook for Market Debt

Over the next few years, the composition of market debt is expected to remain largely unchanged. In 2000-01, debt programs will operate at approximately the same levels as in 1999-2000.

Forecast Composition of Market Debt March 31, 2000²



² Excluding bonds issued to the CPP.

Domestic Debt Programs

To help maintain liquidity in the Government of Canada securities market, the target benchmark sizes for key 5-, 10- and 30-year bonds will be increased.

In 2000-01, bond and Treasury bill programs are expected to operate at levels similar to those in 1999-2000. No restructuring of domestic debt programs is anticipated in the near term.

To maintain transparency and regularity in its debt operations, the Government will continue to borrow in the domestic market on a regular, pre-announced basis. This approach ensures market awareness of future debt operations, attracts a wide range of investors and promotes liquidity. In 2000-01, the Government will continue to hold regularly scheduled quarterly auctions of 2-, 5- and 10-year bonds, and semi-annual auctions for the 30-year bonds. Quarterly auctions of Real Return Bonds will also be held.

To help maintain liquidity in the Government of Canada securities market, the target benchmark sizes for 5-, 10- and 30-year bonds will be increased from \$7-\$10 billion to \$9-\$12 billion. (The target for 2-year bonds will be maintained at \$7-\$10 billion.) This change balances market participants' desire for larger benchmarks with the Government's ability to manage large cash flows at maturity. (A list of outstanding Government of Canada bonds, including maturity dates, can be found in the Debt Management Report – 1998-99, which is available on the Department of Finance Canada Web site at www.fin.gc.ca.)

Bond Buyback Program

To enhance the liquidity of Government of Canada securities, a pilot bond buyback program was implemented in 1998-99. The program allows the Government to buy back existing, less liquid bonds, financed through the issuance of new bonds, thus supporting a liquid new bond issue market.

The pilot bond buyback program will be implemented on an ongoing basis in 2000-01.

An evaluation of the pilot program, which included feedback from market participants, indicates that the program has been successful in meeting its objectives and has been generally helpful to the market. As a result, the Government is implementing the bond buyback program on an ongoing basis in 2000-01. The current reverse auction system on a cash settlement basis will be maintained, with bond buybacks expected to continue to occur on the same day as regular auctions. Buyback transactions used for liquidity maintenance purposes will be announced with the quarterly bond auction.

The size of the buyback program and the number of transactions will depend on a number of factors, including general market conditions and the outlook for the financial balance. As long as the objective of the program remains focused on the maintenance of primary issuance, activity under the program for the next few years will remain modest. Should the program be used for other purposes, the activity level would change – in 2000-01, the use of debt buybacks for cash management purposes will be assessed (more details are provided on page 23).

Stripping and Reconstitution of Bonds

Stripping involves separating bonds into individual interest and principal payment components. Investors choose to strip securities to create new investment products that better match their objectives. Reconstitution is the exact opposite of stripping, and involves combining the stripped components to obtain the underlying security, when it has particular value relative to other securities.

The Investment Dealers Association of Canada has recommended that the Government allow bonds that have been stripped to be reconstituted above the original amount previously stripped by book-entry. The potential benefit of this activity would be to supplement the level of liquidity in current benchmark bonds. Currently, reconstitution of Government of Canada bonds is allowed only up to the amount stripped by book-entry form in The Canadian Depository for Securities Limited. The Government has conducted consultations with a number of market participants and will be reviewing this proposal in early 2000.

Market Integrity

The federal government and the Bank of Canada will continue to work closely with market participants on initiatives to enhance market integrity and transparency. The Government supports further refinements of the CanPx system for the real-time publication of inter-dealer prices.

Electronic Commerce

Electronic commerce (e-commerce) in wholesale fixed-income markets is growing rapidly internationally. In Canada, the federal government has a strong interest in wholesale market e-commerce initiatives which promote the maintenance of liquid and efficient domestic fixed-income markets. The Government and market participants in Canada are discussing proposals made by securities regulators on the regulation of alternative trading systems in the fixed-income markets, as these proposals could have a material impact on transparency and liquidity.

Foreign Debt Programs

Foreign Exchange Reserve Assets

The Government remains committed to maintaining a prudent and appropriate level of foreign exchange reserves.

Reflecting the Government's commitment to raise the level of international reserves, foreign borrowing has become a somewhat larger, although still modest, element of debt operations. In the 1996 budget, the Government indicated its intention to increase Canada's foreign exchange reserves, in response to increased flows in foreign exchange markets and to maintain a prudent level of liquid reserves in line with comparable countries. This commitment was reaffirmed in the 1998 budget. Canada's foreign exchange reserves have more than doubled from US\$14.8 billion at the end of March 1995 to US\$29.9 billion at the end of February 2000. With these increases, the Government has made substantial progress in ensuring that it has a prudent level of foreign exchange reserves that is in line with that of other comparable sovereigns. Further details on the management of international reserves are available in *The Exchange Fund Account Annual Report*, which is available from Public Works and Government Services Canada.

Funding Foreign Exchange Reserves

Foreign currency debt operations are driven by foreign exchange reserve needs.

The Government has access to a wide range of sources to fund its foreign exchange reserves. These sources include a short-term US-dollar discount note program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps have been a particularly cost-effective alternative to foreign currency denominated bond issues, and have been actively used in recent years. Swap activity involves the exchange of contractual obligations (e.g. the exchange of a principal amount of currency and periodic interest payments, and a commitment to re-exchange the principal amount at maturity), and thus exposes the Government to the risk of counterparty default. The Government manages the counterparty credit exposure associated with cross-currency swaps in a prudent manner.

Foreign exchange liabilities have grown significantly in recent years, in particular during 1998-99, a period of extensive foreign exchange intervention and important commitments to the International Monetary Fund. As a result, foreign exchange liabilities grew to exceed foreign currency assets in the Exchange Fund Account. Purchases of US dollars in foreign exchange markets, as one of the funding sources of the Government for its foreign exchange reserves, are being used to reduce the mismatch between foreign currency liabilities and assets. The Government plans to continue to bring foreign currency liabilities more in line with foreign currency assets in a gradual and prudent manner over time.

The Government was less active in public foreign markets last year than in previous years, as purchases of US dollars and cross-currency swaps of domestic obligations served as the primary sources of funding. These sources were supplemented by one large US dollar global bond issue, which was executed in response to favourable market opportunities.

Table 1

*Sources and Requirements of Foreign Exchange Reserves,
April 1 – December 31, 1999*

	(billions of US dollars)
Sources of reserves:	
Purchases of US dollars	3.8
Cross-currency swaps	2.8
Public market borrowings	2.0
Total sources	8.6
Foreign exchange reserve requirements:	
Net maturing debt	(3.9)
Net foreign exchange debt charges	(0.2)
Government requirements and other	(0.7)
Requirements	(4.8)
Increase in foreign exchange reserves	3.8

Purchases of foreign exchange and the use of cross-currency swaps to fund reserves will be continued.

In 2000-01, as in previous years, the mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-denominated debt maturity structure.

Management of the Government's Cash Balances

The Government manages its cash balances in order to ensure that it has sufficient cash on hand to meet its daily operational requirements, which can at times be volatile and difficult to forecast. Thus, substantial cash balances are often held.

Cash Management Framework

The Department of Finance and the Bank of Canada are consulting with market participants on changes to the cash management system framework. Currently, cash balances are invested as term deposits with direct participants in the Large Value Transfer System. Deposits are placed with the institutions through an auction process in order to earn competitive market rates of return. Changes under consideration include broadening access to bidding for balances, and introducing a credit framework to govern the investment process. The Department of Finance and the Bank of Canada are preparing a public discussion paper on this initiative.

Bond Buybacks for Cash Management

*Buybacks
will be assessed
for cash
management
purposes
begining in
2000 -01.*

In 2000-01, an expansion of the existing bond buyback program to include cash management will be assessed. In contrast to the buyback program for liquidity maintenance purposes, this would involve buying back maturing bonds. These bond buybacks would help in smoothing the Government's debt repayment schedule, allowing greater control over cash balances and ongoing borrowing requirements. These potential operations will be discussed with market participants during the year.

2000-01 Federal Debt Programs

Plans for market debt programs are based on the 2000 budget outlook.

The federal debt management strategy for each debt program is presented below. The strategy is based on the 2000 budget outlook for financial surpluses (excluding foreign exchange transactions): the forecast is for a surplus of \$8 billion for 1999-2000 and a financial requirement of \$5 billion for 2000-01.

The plan has been developed in consultation with market participants. The federal government will continue to consult with market participants in fiscal year 2000-01 on potential adjustments in order to maintain a well-functioning market in the changing debt management environment.

The federal government uses a variety of instruments to fund its domestic operations:

- fixed-rate marketable bonds;
- Real Return Bonds;
- Treasury bills; and
- retail non-marketable debt (primarily Canada Savings Bonds and Canada Premium Bonds).

The foreign currency borrowing program is used to fund Canada's foreign exchange reserves.

The planned level of issuance for the fixed-rate marketable bond program in 2000-01 will be similar to that of 1999-2000.

Fixed-Rate Marketable Bonds

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. In 2000-01, about \$34 billion in bonds will be maturing.

Taking into account buyback operations and foreign funding activity, it is planned that gross issuance under the 2000-01 bond program will total about \$45 billion, which is similar to the 1999-2000 level.

Real Return Bonds (RRBs)

The target for Real Return Bonds will be maintained.

As in 1999-2000, the federal government plans to issue up to \$2 billion in RRBs in 2000-01. In 1999-2000, \$1.25 billion in RRBs were issued.

The Treasury bill program is expected to operate at levels similar to those in 1999-2000.

Treasury Bills

The Treasury bill stock varies over the year largely as a result of changes in the Government's funding and cash needs. In 2000-01, based on the fiscal plan in the budget, the stock at year-end is expected to total about \$100 billion, similar to the 1999-2000 level.

Retail debt is an important part of the Government's debt program.

Retail Debt

Canada Investment and Savings (CI&S) contributes to the diversification of the investor base. The objective of the retail debt program is to provide cost-effective funding for the Government and to encourage Canadians to invest in Canada.

The retail debt plan will be released later in 2000 by CI&S.

Canada Pension Plan (CPP) Bonds

CPP bonds are largely 20-year bonds issued by the Government of Canada to the CPP in the past. As new CPP contributions are now invested in the market, no new bonds will be issued under this program.

Foreign funding activity will be spread across a range of funding sources.

Foreign Currency Debt Programs

The principal source of funding for the foreign exchange reserves is expected to be purchases of US dollars. Use of cross-currency swaps of domestic obligations will also be continued. These programs are expected to be used less than in prior years. Medium-term note issuance in various markets and occasional large international bond issues may also be required.

Glossary

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

bid: Price a buyer is ready to pay. The **bid-offer spread** is the difference between bid and offer prices.

book-entry: The form in which the majority of Government of Canada fixed-income securities are held and issued. Book-entry form consists of an electronic ledger entry at The Canadian Depository for Securities Limited (CDS). No physical bond certificate is sent to the owner of the security but is held in safekeeping at the CDS.

budgetary surplus: The amount by which government revenues exceed budgetary spending in any given year. A **deficit** is the amount by which government budgetary spending exceeds revenues in any given year.

Canada Pension Plan bond: Non-negotiable and non-transferable bond issued by the Government of Canada to the Canada Pension Plan.

Canada Premium Bond (CPB): A savings product for individual Canadians introduced by the Government of Canada in 1998. It offers a higher interest rate compared to the Canada Savings Bond and is redeemable once a year on the anniversary of the issue date or during the 30 days thereafter without penalty.

Canada Savings Bond (CSB): A savings product currently offered for sale by most Canadian financial institutions to individual Canadians. CSBs pay a competitive rate of interest which is guaranteed for one or more years. They may be cashed at any time and, after the first three months, pay interest up to the end of the month prior to encashment.

CanPx: A transparency system that provides real-time price and transaction information for key benchmark issues of Canadian government bonds and Treasury bills. Over time, the system will be expanded to include other actively traded government securities.

Contingency Reserve: The Contingency Reserve is included in the budget projections primarily to provide an extra measure of protection against adverse errors in the economic forecast. It is not a source of funding for new policy initiatives.

counterparty credit exposure: The risk the Government faces through the default of a counterparty on its contractual obligations.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

discount note: Short-term debt security where the yield is provided through a discounted selling price relative to the face value of the note.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar on the foreign exchange market and for general liquidity purposes.

financial balance (excluding foreign exchange transactions): Measures the difference between the cash coming in to the Government and the cash going out. In the case of a financial requirement, it is therefore the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fixed-rate marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian dollar fixed-rate marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

foreign exchange reserves: Stocks of foreign exchange assets (e.g. interest-earning bonds) held by sovereign states to support the value of the domestic currency. Canada's foreign exchange reserves are held in a special account called the Exchange Fund Account.

gross public debt: Total amount the Government owes. It consists of market debt in the form of outstanding securities such as Treasury bills and Canada Savings Bonds, internal debt owed mainly to the superannuation fund for government employees and other current liabilities.

inter-dealer broker: A broker who acts as an intermediary between dealers buying and selling Government of Canada securities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

liquidity: Characterization of a market with good trading volumes, where trades of medium and even large sizes can be effected quickly without materially affecting the price.

market debt: The portion of debt that is funded in the public markets. It includes fixed-rate marketable bonds, Real Return Bonds, Treasury bills, retail debt (primarily Canada Savings Bonds and Canada Premium Bonds), foreign currency denominated bonds and bills, and bonds issued to the Canada Pension Plan.

medium-term notes (MTNs): MTNs are issued in various currencies outside Canada with terms to maturity generally beyond one year. MTNs are issued for foreign exchange reserve funding purposes only.

net public debt: Consists of interest-bearing debt and other liabilities, net of financial assets.

non-market debt: Includes the Government's internal debt, which is for the most part federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest and payment of matured debt).

primary market: Market for new issues of securities.

Real Return Bond (RRB): Government of Canada RRBs pay semi-annual interest based on a real interest rate. Unlike standard fixed-rate marketable bonds, interest payments on RRBs are adjusted for changes in the consumer price index.

reverse auction: The reverse of a regular or conventional bond auction. Bidders submit an offer to sell a security rather than offers to buy the security.

secondary market: Market where securities are bought and sold after issuance.

sovereign market: Market for the debt issued by a government.

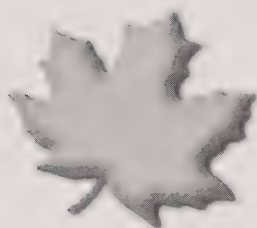
transparency: Characterization of a market where debt management strategies and operations are known and well understood by market participants.

Treasury bill: Short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6, or 12 months are currently auctioned on a biweekly basis.

turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

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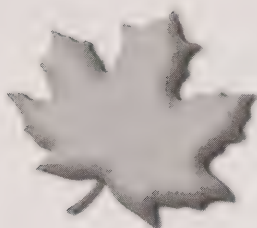


DEBT MANAGEMENT STRATEGY

2001-2002



Canada



DEBT MANAGEMENT STRATEGY

2001-2002



Department of Finance
Canada

Ministère des Finances
Canada

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Foreword by the Minister of Finance

I am pleased to table before Parliament the *Debt Management Strategy* of the Government of Canada for fiscal year 2001-02. This marks the second consecutive year that the Government has tabled the *Debt Management Strategy*, in keeping with the changes made in 1999 to the Financial Administration Act.

The commitment to sound financial management will once again be fulfilled as the Government expects to report a surplus of at least \$10 billion in 2000-01, marking the fourth consecutive year in which a surplus has been recorded. Taking into account the tax cuts and spending initiatives announced in the February 2000 budget and the *Economic Statement and Budget Update* of October 2000, the Government is committed to maintaining balanced budgets or better in 2001-02 and 2002-03. This will mean six consecutive years of balanced budgets or surpluses, an accomplishment that has not been matched in the past 50 years.

From a post-war peak of 71.2 per cent in 1995-96, the debt-to-GDP ratio will fall to about 54 per cent in 2000-01 and is projected to fall to about 40 per cent by 2005-06. This is important because as the ratio declines, Canada's public debt becomes less of a burden for Canadian taxpayers. As such, the Government's ongoing effort to reduce federal debt continues to pay dividends for all Canadians.

That being said, the level of debt remains significant and needs to be well managed. It is thus important to ensure that debt-servicing costs are kept low and stable. A crucial element of this objective is the management of the Government's market debt. This is the focus of the *Debt Management Strategy*, which provides comprehensive information on the Government's debt management plans for the coming fiscal year.

The Government's intention in tabling this document is to ensure all Canadians are aware of this strategy and the results it is intended to achieve.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, February 27, 2001

Highlights of the 2001-02 Debt Strategy

- The target fixed-rate share of the debt will be maintained at two-thirds.
- No major restructuring of domestic debt programs is planned in 2001-02. Bond and Treasury bill programs are expected to operate at levels similar to those of 2000-01.
- To enhance the liquidity of the Government of Canada securities market, the target benchmarks for 10- and 30-year bonds will be increased from \$9 billion-\$12 billion to \$12 billion-\$15 billion.
- To facilitate cash management, the 30-year issuance pattern will be adjusted by adding a third issue in 2001-02. The one-time additional issuance will be substantially offset by bond buybacks of outstanding long-term bonds, and is thus not related to the Government's projected borrowing needs.
- To improve the transparency and effectiveness of the bond buyback program, bond buyback operations will be more frequent, encompassing a range of maturities, with target volumes announced quarterly with the bond auction schedule.
- The cash management bond buyback pilot program will be extended into 2001-02.
- To reduce risk and broaden access, the Government is developing a new framework for the management of cash balances.
- Discussions will continue with market participants and regulators on enhancing the integrity and regulation of the Government of Canada securities market.

Debt Management Framework

This section outlines the federal government's objectives in managing federal market debt and the key principles underlying the pursuit of these objectives. (To assist readers unfamiliar with the technical terminology of debt management, a glossary is provided at the end of this document.)

Debt Management Objectives

The federal government pursues two main objectives in managing market debt:

- The fundamental objective continues to be to provide stable, low-cost funding for the Government.
- A related important objective is to maintain a well-functioning market for Government of Canada securities.

Domestic Debt Management

Principles

- Consistent with the practice of many sovereigns, funding for the Government's domestic financial requirements is raised in the domestic market in Canadian dollars.
- In order to maintain a well-functioning domestic market and keep borrowing costs low, the Government focuses on the key aspects of liquidity, transparency, regularity and integrity. For this reason, the Government borrows on a regular, pre-announced basis in key segments of the market, builds large bond benchmarks and maintains effective rules for participation at Government of Canada security auctions.
- Given the key role played by federal government securities in Canada's fixed-income market, market participants are consulted extensively on the Government's debt strategy and adjustments to its domestic debt programs.

General Strategy

- The primary focus of debt management strategy is the structure of the debt, as the exposure to changes in interest rates inherent in the maturity profile of the debt stock can impact debt costs. The Government structures the debt to provide reasonable cost stability under a range of potential interest rate environments and a balanced maturity profile. The target debt structure is not based on a particular interest rate outlook.
- Large benchmarks in Treasury bills and Government of Canada bonds are maintained to promote market liquidity.
- The Government maintains a diversified investor base.

The fundamental debt management objective is to provide stable, low-cost funding for the Government.

Foreign Currency Debt Management

Principles

Borrowings in foreign currencies fund Canada's foreign exchange reserves.

- Foreign currency borrowings by the Government are used to fund Canada's foreign exchange reserves.
- Major risks, including currency risk and interest rate risk, are largely immunized by investing borrowings in matching assets of high credit quality.

General Strategy

- The Government finances foreign exchange reserves through a range of programs, the use of which is determined by asset portfolio objectives, cost, maturity profile and market conditions.
- In general, there is a modest cost to holding reserves, as the yield on high quality assets is slightly less than the cost of funding. Liabilities are managed in conjunction with the reserve assets to limit the cost of holding reserves, and a prudent maturity structure is maintained to limit refinancing needs.
- The Government's foreign exchange reserves are held predominantly in US dollars, with a small portion in euro- and yen-denominated reserves.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government is committed to balanced budgets or better in 2001-02 and 2002-03.

The Government's fiscal policy sets the context for debt management operations. In the October 2000 *Economic Statement and Budget Update*, the Government committed to paying down a minimum of \$10 billion of net public debt in 2000-01, bringing the total debt paydown over the last four years to at least \$28.7 billion. The Government will continue to follow a prudent approach to budget planning as set out in its Debt Repayment Plan. Taking into account the tax cuts and spending initiatives announced since the February 2000 budget, including the new measures announced in the *Economic Statement and Budget Update*, the Government is committed to maintaining balanced budgets or better in 2001-02 and 2002-03. This will mean six consecutive years of balanced budgets or surpluses – a performance not matched in the past 50 years.

The net public debt burden is expected to decline over time.

Consistent with the Debt Repayment Plan, the Government will continue to use the contingency reserve to reduce the net public debt in those years when it is not required. Furthermore, the Government has added an important new element to the Debt Repayment Plan. Each fall it will announce whether more of that year's surplus should be dedicated to debt paydown, depending on the economic and fiscal circumstances at that time.

The Debt Repayment Plan

The prudent approach to budget planning contained in the Government's Debt Repayment Plan will continue. This entails:

- continuing to use the average of private sector economic forecasts for budget-planning purposes;
- continuing the practice of setting aside an annual \$3-billion contingency reserve, which, if not needed, will be used to pay down the public debt;
- continuing to add an extra degree of economic prudence to provide further assurance against falling back into a deficit; and
- announcing each fall whether more of that year's surplus should be dedicated to debt paydown – the amount would depend on the economic and fiscal circumstances at that time.

This enhanced Debt Repayment Plan, combined with sustained economic growth, will ensure that the debt-to-GDP (gross domestic product) ratio – the level of debt in relation to the country's annual income – remains on a permanent downward track. From a peak of 71.2 per cent in 1995-96, the debt-to-GDP ratio will fall to about 54 per cent in 2000-01 and is projected to fall to about 40 per cent by 2005-06. This would take the ratio back to where it was in 1983-84.

Financial Balance

The key budgetary measure for debt management planning is the financial balance (see box on next page). In general, balanced budgets can be expected to reduce market debt as they are normally accompanied by financial sources. However, the precise relationship between the budgetary balance and the financial balance will vary from year to year, as it depends in large part on the timing of cash payments. The budgetary balance is largely presented on an accrual basis of accounting, including liabilities when incurred, whereas the financial balance is presented on a cash basis of accounting.

For 2000-01 the Government is committed to paying down at least \$10 billion in net public debt. Consistent with this commitment, the Government is projecting a financial source of \$3 billion. The difference primarily reflects a number of one-time cash payments, which on a budgetary basis were recorded in previous years. These are the \$2.5-billion health supplement paid under the Canada Health and Social Transfer and pay equity payments made subsequent to the ruling of the Canadian Human Rights Tribunal. In addition, the reforms to the public sector pension plans, whereby contributions are now invested in the private capital market, have permanently reduced the difference between the budgetary balance and the financial balance. Further, a number of Crown corporations that are currently members of the public sector pension plan will be establishing their own pension plans. The Government will transfer to these corporations the actuarial value of their accrued assets over the 2000-01 to 2002-03 period.

For 2001-02 the Government has committed to a balanced budget or better. Consistent with this commitment and a net requirement from non-budgetary transactions of \$3 billion, the Government is projecting a financial requirement of \$3 billion. However, the balanced budget target includes the contingency reserve of \$3 billion and normal economic prudence of \$1 billion. The contingency reserve, if not needed, would be applied to reducing the debt. In addition, the budget plan for the year includes a remaining balance of \$4.3 billion. As indicated by the Minister of Finance in the October 2000 *Economic Statement and Budget Update*, some of this remaining balance could also be directed to further debt reduction.

The Budgetary Balance and Financial Balance

The budgetary balance – deficit/surplus – is one measure of the Government's financial situation. It is presented on a modified basis of accounting, recording liabilities when they are incurred, regardless of when the actual cash payment is made.

The financial balance – requirements/source – provides a measure of the net cash requirements needed to fund the Government's programs and debt charges. The difference between the financial balance and the budgetary balance is due to a number of non-budgetary transactions that provide funds to the Government. Non-budgetary transactions convert the accrual-based concepts in the budgetary balance to cash-based financial requirements. Excluding foreign exchange requirements, the Government recorded a financial source in each of the last four years.

The net financial balance includes foreign exchange transactions, which represent all transactions in international reserves held in the Exchange Fund Account. Including these transactions, the Government recorded a source in each of the last three years.

Foreign Exchange Transactions

The Government ensures that it holds a prudent level of foreign exchange reserves.

In recent years foreign exchange transactions, although modest, have resulted in a reduction in the net financial balance. However, to the extent that they increase Canada's foreign exchange reserves, these transactions do not change the level of the net public debt. Foreign reserves are high quality financial assets of the Government, thus offsetting foreign exchange liabilities.

Market Debt Impact

Market debt declined by \$4.0 billion in 1999-2000, bringing total market debt retirement over the past three years to over \$20 billion. Additional market debt retirements are projected for 2000-01. While market debt is generally on a downward track, it is expected to remain largely unchanged in 2001-02, primarily due to financial requirements associated with public sector pension reform.

No additional market borrowing is expected to be required in 2001-02.

The Government is positioning itself to meet any planned non-budgetary transactions in 2001-02 without any additional borrowing, largely through an increase in cash balances this year. If necessary, the Government can draw on the existing amount of \$4 billion in non-lapsing borrowing authority.

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained to raise new debt in the form of a borrowing authority bill.

Currently available borrowing authority is limited to a \$4-billion non-lapsing contingency from the 1996-97 Borrowing Authority Act.

Debt Structure and Holdings

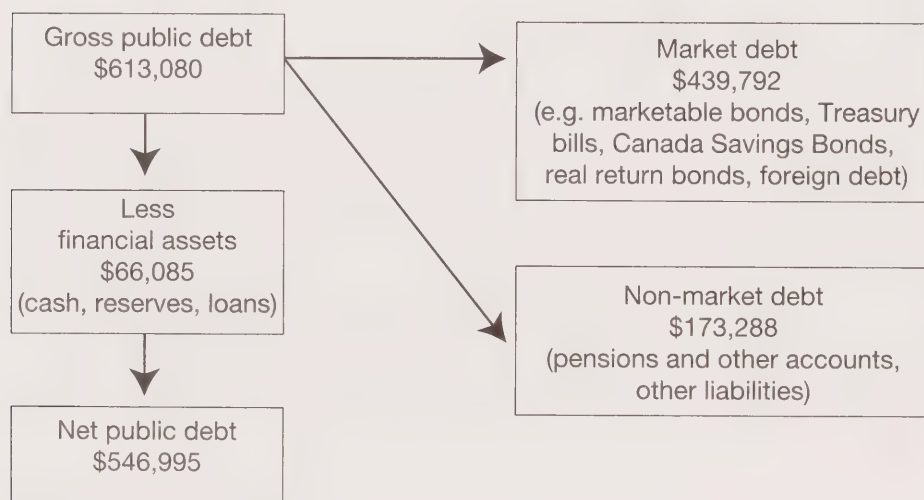
Debt management operations focus on market debt, which is only one component of the public debt. The other component – non-market debt – is taken into account in debt strategy planning, but is not actively managed. Non-market debt includes federal public sector pension liabilities and the Government's current liabilities.

The federal government's market debt consists mainly of fixed-rate marketable bonds, real return bonds, Treasury bills, retail non-marketable debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt.

The chart below illustrates the relationships between the components of the public debt.

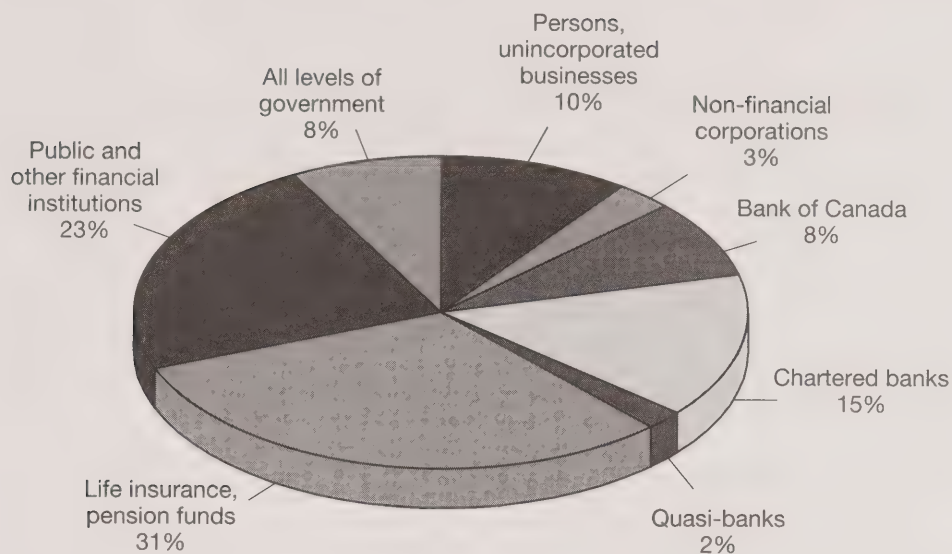
Total Public Debt as at December 31, 2000

(in millions of dollars)



Source: Department of Finance Canada, *The Fiscal Monitor* (results for December 2000), February 13, 2001.

Distribution of Domestic Holdings of Government of Canada Market Debt



Source: Statistics Canada, *National Balance Sheet Accounts – 1999*.

Note: Includes investment dealers, mutual funds, fire and casualty insurance companies, sales, finance and consumer loan companies, accident and sickness branches of life insurance companies, other private financial institutions (not elsewhere included), federal public financial institutions, and provincial financial institutions.

A wide range of institutional and retail investors hold federal government debt. Non-resident holdings of Government of Canada debt have been declining in the past few years, decreasing from a peak of 28 per cent of total market debt in 1993 to around 22 per cent today.

2001-02 Debt Management Strategy

Raise Stable, Low-Cost Financing

Maintaining a Prudent Debt Structure

While the Government's fiscal position has improved considerably in recent years with the elimination of the deficit, the stock of outstanding debt remains large. Moreover, Canada's debt stock is exposed to interest rate changes originating in Canada and around the world. Interest rate shocks can significantly affect the level of annual debt charges, as the portion of debt that is rolling over must be issued at the new prevailing market interest rates. Including multiple refinancings of maturing short-term Treasury bills, some \$262 billion of federal market debt will be maturing or repriced over the 2001-02 fiscal year.

Determining the Debt Structure Target

Given the large stock of outstanding debt, the Government's debt strategy aims to keep debt-servicing costs low and stable over time, while ensuring that a well-functioning market for Government of Canada securities is maintained. A prudent debt structure is maintained to limit exposure to unexpected changes in interest rates and keep a balanced maturity profile, which serves to maintain investor and credit rating agency confidence.

The debt structure target is reviewed annually to assess its ongoing suitability given changes in the fiscal and economic environment. For 2001-02, the target fixed-rate share of the debt will be maintained at two-thirds.

The Government has put in place a prudent debt structure by altering the term structure of its debt, specifically by issuing more long-term debt and less short-term debt. While there are a number of indicators that can be used to assess the debt structure – fixed/floating ratio, average term to maturity, duration, Cost at Risk – the Government's key target is the share of interest-bearing debt issued at fixed rates (i.e. maturing or repriced beyond one year). Greater stability of debt-servicing costs has been achieved over the past several years by increasing the share issued at fixed rates from about 50 per cent in 1992-93 to about two-thirds in 1998-99, where it is currently.

As part of debt strategy planning, the debt structure target is reviewed annually to assess its ongoing suitability given changes in the fiscal and economic environment, and to ensure that it remains consistent with the best practices of other sovereign borrowers. For 2001-02, the target fixed-rate share of the debt will remain at two-thirds.

Implications of the Target Debt Structure

The Government uses a number of indicators in assessing the implications of the target debt structure.

The impact of a 100-basis-point increase in interest rates on debt charges has been cut in half since the mid-1990s.

The Government's decision to maintain the fixed-rate share of the debt at two-thirds ensures that the debt stock is less sensitive to changes in interest rates. A 100-basis-point increase in interest rates would now raise public debt charges by \$0.9 billion in the first year; in the mid-1990s, the first-year impact of a 100-basis-point increase was estimated at about \$1.8 billion.

A further benefit of maintaining the fixed debt structure at two-thirds is that it limits the need to refinance a large portion of the debt in any given period. In 1995, when the fixed-rate share of the debt was at 55 per cent, the Government was required to refinance, on average, \$8 billion per week in maturing Treasury bills. Today the Government only needs to refinance \$4 billion per week. At the same time, the one-third share of floating-rate debt allows for lower debt-servicing costs should short-term rates remain lower than long-term rates.

Maintaining a higher fixed-rate share of debt may, however, give rise to increased debt-servicing costs for the Government since short-term funds are usually cheaper relative to long-term funds. By way of illustration, debt-servicing costs would differ by \$100 million next year for a 5-percentage-point difference in the debt structure. That is, given the forecast for interest rates contained in the October 2000 *Economic Statement and Budget Update* and the maturity profile of various types of government debt, the cost of a 5-per-cent higher fixed stock (72 per cent) would be \$100 million more next fiscal year than the two-thirds target structure, while a 5-per-cent lower fixed stock (62 per cent) would result in a reduction of debt costs of \$100 million over the next fiscal year. The difference in the cost of alternative debt structures is affected by the slope of the yield curve, which at present is somewhat flatter than in recent years.

The two-thirds fixed-rate structure limits the fiscal impact of interest rate shocks.

Cost at Risk analysis, which evaluates debt costs under multiple interest rate paths (see box on next page), indicates that there are benefits to maintaining a two-thirds target debt rate structure relative to a lower fixed structure. Specifically, the analysis indicates that the two-thirds fixed-rate structure is highly likely to limit the fiscal impact of interest rate shocks to less than the \$3-billion contingency reserve over the two-year budget horizon. While this would also be true of a higher fixed-rate structure, debt-servicing costs would also be higher. Under worst-case scenarios of significantly higher interest rates that continue for some time, debt-servicing costs under the current structure would be less affected than under a lower fixed-rate structure.

The Government takes a long-term strategic view of the debt structure, balancing the benefits of greater stability in debt-servicing costs, given the greater volatility in short-term interest rates, against the costs of achieving stability. As well, debt structure decisions take into account the inherent unpredictability associated with the long-term path of interest rates, as they will change significantly over time due

to both internal and external developments. On balance, the Government has adopted a prudent structure, similar to that maintained by other comparable sovereigns.

Cost at Risk Analysis

The Government recently expanded its long-term analytical capabilities with the introduction of a measure known as Cost at Risk (CaR), which is used by a number of sovereign borrowers to assess the cost and risk associated with different debt structures. Calculation of CaR is based on the future interest costs of a given debt stock under numerous different interest rate scenarios, and allows a comparison of the long-term interest rate risk of alternative debt structures. On the basis of these scenarios, a probability distribution of costs can be determined.

CaR depends largely on the assumptions used to simulate scenarios; changes in modelling techniques and the interest rate environment will change results from year to year. However, CaR is an important supplement to established measures such as the fixed-rate share and the maturity profile.

Maintaining a Diversified Investor Base

A diversified investor base is maintained to ensure funding costs are kept low.

Maintaining a diversified investor base is also an important factor in ensuring that funding costs are kept low. The federal government pursues diversification of its investor base through the maintenance of liquid and transparent domestic wholesale debt programs and internationally through the use of a broad array of sources of funds. In addition, Canada Investment and Savings, the Government's retail debt agency, contributes to the maintenance of a diversified investor base by offering savings products designed to suit the needs of a large number of individual Canadians.

Maintaining a well-functioning Government of Canada securities market remains a high priority for the federal government.

Maintain and Enhance a Well-Functioning Market

Maintaining a well-functioning Government of Canada securities market, by focusing on the key aspects of liquidity, transparency, regularity and integrity, remains a high priority for the federal government in the general environment of declining market debt. A well-functioning Government of Canada securities market provides low-cost financing for the Government by promoting broader participation in the market. It is also of general benefit to the domestic capital market, where benchmark federal securities are key investments; because they are actively traded, these securities provide important pricing and hedging tools.

The Government will continue to maintain the principles of liquidity, transparency, regularity and integrity in its debt programs.

A number of initiatives have been pursued by the Government to ensure that a well-functioning Government of Canada securities market is maintained.

No major restructuring of domestic debt programs is planned in 2001-02.

The federal government actively pursues initiatives designed to ensure that the quality and integrity of the Government of Canada securities market is maintained, and that the market continues to be one of the most liquid and efficient sovereign markets in the world, featuring tight bid-offer spreads, large transaction volumes and high turnover ratios.

Past Debt Strategy Initiatives

The federal government pursued a number of initiatives in 2000-01, including:

- increasing the target benchmark sizes for 5-, 10- and 30-year bonds to enhance the liquidity and attractiveness of the Government of Canada securities market;
- implementing, on an ongoing basis, the bond buyback program to support the maintenance of a liquid new bond issue market;
- reviewing the structure of the Treasury bill program to ensure it continues to function well;
- implementing a pilot bond buyback program for cash management purposes;
- approving new rules related to the stripping and reconstitution of Government of Canada bonds;
- continuing discussions with market participants and regulators on the development of electronic trading systems in the domestic fixed-income market; and
- releasing a discussion paper proposing changes to the cash management system framework, including broadening access to bidding for balances and introducing a credit framework to govern the investment process.

2001-02 Debt Strategy Initiatives

Domestic Debt Programs

Given that domestic debt programs are expected to operate at similar levels to those of 2000-01, no major restructuring is planned in the near term. In the development of the 2001-02 debt strategy, market participants were consulted on the desirability of restructuring the Treasury bill program to improve liquidity. The general consensus was that, provided the stock remains near current levels (i.e. in the range of \$75 billion to \$95 billion), no change is needed to the structure of the Treasury bill program. The domestic bond program will continue to have four benchmark maturities (2, 5, 10 and 30 years) as well as a real return bond benchmark.

To maintain transparency in its debt operations, the Government will continue to borrow in the domestic market on a regular, pre-announced basis. This approach ensures market awareness of upcoming debt operations, attracts a wide range of investors and promotes secondary market liquidity.

In 2001-02 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and real return bonds.

The 30-year issuance pattern will be adjusted to facilitate cash management.

To facilitate cash management, the Government will adjust the semi-annual issuance pattern for 30-year bonds, switching from spring/fall to summer/winter. Currently the 30-year bond auctions are held in quarters where cash balances are already high. By altering the issuance pattern of the 30-year bonds, the Government will better match the issuance cycle to its cash flow needs. This will be achieved by adding a third 30-year issue in the fourth quarter of fiscal year 2001-02. The one-time issuance will be substantially offset by buybacks (see below) of outstanding long-term bonds, and is thus not related to the Government's projected borrowing needs.

Benchmark targets and planned reopening periods for 10- and 30-year bonds are being increased.

In consultations market participants expressed a desire for increased liquidity in longer-dated bonds. Therefore, in order to promote liquidity and trading in benchmark Government of Canada securities, the benchmark targets for 10- and 30-year bonds are being increased from \$9 billion-\$12 billion to \$12 billion-\$15 billion. The increased benchmark size will be achieved through extended reopening periods (new issues of bonds are generally reopened several times to increase the size of the issue to the target benchmark size). As is currently the practice, the Government and the Bank of Canada will continue to consult with government securities distributors prior to making a decision on whether a particular auction will be a new issue or a reopening. These decisions will continue to be announced with the release of the *Call for Tender*. The targets for 2- and 5-year bonds will be maintained at \$7 billion to \$10 billion and \$9 billion to \$12 billion, respectively.

Bond Buybacks

To enhance liquidity in the market for Government of Canada securities, a bond buyback program was introduced in 1998-99 and implemented on an ongoing basis in 2000-01. The program allows the Government to buy back existing less liquid bonds, financed through the issuance of new bonds, thus supporting a liquid new bond issue market. (A list of outstanding Government of Canada bonds, including maturity dates, can be found in the *Debt Management Report 1999-2000*, which is available on the Department of Finance Web site at www.fin.gc.ca. A list is also available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be available on the Bank of Canada's Web site at www.bankofcanada.ca.)

Bond buyback operations will be more frequent, encompassing a range of maturities, with target volumes announced quarterly with the bond auction schedule.

The planned size of the bond buyback program and the number of transactions depend on a number of factors, including the desired size of the new issuance and buyback programs, market feedback and financial requirements. In 2001-02 it is expected that buyback volumes will be modestly greater than in 2000-01. To enhance transparency and participation, the Government will increase the frequency of bond buyback operations and will announce the total target volume for each quarter in the quarterly bond auction schedule published by the Bank of Canada. (The current schedule is available on the Bank of Canada's Web site at www.bankofcanada.ca.)

Bond Buybacks for Cash Management

The cash management bond buyback pilot program will be extended into 2001-02.

To help in smoothing the Government's cash requirements, a pilot program of cash management bond buybacks was implemented in 2000-01. The purpose of the program is to reduce the peak levels of government cash balances needed to redeem upcoming benchmark bond maturities. In contrast to the buyback program for liquidity maintenance purposes, this involves buying back bonds with less than 12 months to maturity. The pilot program will be continued in 2001-02 as operational issues are assessed. An evaluation involving consultations with market participants will be conducted during the year to determine whether it is meeting objectives and can become a regular part of the Government's debt management operations.

Primary Market Enhancements

Communications with market participants will be ongoing in 2001-02 on operational enhancements to debt programs.

In 2000-01 the Government made adjustments to debt programs to enhance the functioning of the market for Government of Canada securities. Market participants were consulted on proposed initiatives through notices and information posted on the Bank of Canada's Web site (www.bankofcanada.ca). Through this approach, the Government seeks to maintain a high standard of transparency, improve operational flexibility and obtain external input into its decisions on debt management operations.

In 2001-02 this process will continue. Initiatives currently contemplated are the continued reduction in auction result turnaround time, as well as evaluation of alternative methodologies for bond buybacks.

Domestic Market Initiatives and Integrity

The Government has a strong interest in ensuring the well functioning and integrity of the market for fixed-income securities, particularly Government of Canada securities, which are the benchmark of the market. The Government of Canada securities market is a highly liquid market, primarily involving professional financial institutions, which serves the interests of Canadian taxpayers and a wide range of fixed-income market participants.

Discussions with market participants and securities regulators on enhancing market integrity and regulation are ongoing.

Given the rapid advance of electronic trading in fixed-income markets, the Canadian Securities Administrators (CSA) have made proposals for the regulation of electronic trading and for the appropriate framework for the regulation of the domestic fixed-income market. The Department of Finance and the Bank of Canada have an active dialogue with the CSA and market participants on these matters. Given the nature of the marketplace, the Government's preferred approach is to avoid imposing unnecessary and potentially burdensome regulatory structures, while continuing to deal with public interest issues as they arise, in full consultation with market participants and the CSA.

The Government is encouraging the development of greater transparency of the secondary market for Government of Canada securities.

In this context, the Government is supporting the enhancement of transparency mechanisms. A current initiative is the further development of the CanPx system. A screen-based, real-time information system established by dealers and inter-dealer brokers in 1999, CanPx provides market participants with best bid and offer prices and trading volumes in a range of benchmark fixed-income securities in the inter-dealer marketplace. The CanPx system, which has yet to operate in the manner intended due to technical problems, is being fixed and expanded in 2001 to ensure market participants are provided with a high standard of transparency.

Management of the Government's Cash Balances

The Government manages its cash balances in order to ensure that it has sufficient cash on hand to meet its daily operational requirements, which can be volatile and difficult to forecast at times. Thus, substantial cash balances are often held.

The federal government is developing a new framework for the management of cash balances in 2001-02.

In July 2000 the Department of Finance and the Bank of Canada released a public discussion paper on proposed changes to the cash management framework. Under the current framework, cash balances are placed with direct participants in the Large Value Transfer System through a competitive auction process. The federal government is developing a new framework, based on the feedback received from market participants, which includes the introduction of a credit management system to better manage the risk of investing its cash balances and to support the broadening of participation in the bidding process.

Foreign Debt Programs

Foreign Exchange Reserve Assets

The Government remains committed to maintaining a prudent and appropriate level of foreign exchange reserves.

The Government's foreign exchange reserve assets provide it with foreign currency liquidity and ensure that it is able to meet international requirements or unforeseen obligations at all times. Reserves may also be used for intervention in the foreign exchange markets to promote orderly conditions for the Canadian dollar. (Further detail on the management of international reserves is available in *Exchange Fund Account – Annual Report*, available on the Department of Finance Web site at www.fin.gc.ca.)

In recent years the Government has increased the level of foreign exchange reserves to bring them in line with those of other comparable sovereigns. The foreign currency reserve assets and the liabilities financing those assets are managed on a portfolio basis, based on many of the same principles used by private sector financial institutions, including prudent risk management principles. In this regard, interest rate and currency risks are immunized to the extent possible. On the asset side, attention needs to be paid to asset liquidity and quality, diversification and credit limits with counterparties. On the liability side, the same attention is paid to diversified means of raising funds and a diversified investor base, as well as the cost of different sources of funds and the maturity profile of the liabilities.

Key considerations in managing the foreign currency reserve assets and liabilities are minimizing the cost of carrying reserves and prudently managing risk.

One consideration in managing reserve assets and liabilities is to minimize the cost of carrying reserves. The main strategy used to reduce this cost has been to modify the composition of Exchange Fund Account assets by shifting a portion of the Government's investments in sovereign issues to other higher-yielding but still liquid high quality, fixed-income securities. These securities bear returns near the rate of interest Canada pays on its foreign liabilities. To further reduce carrying costs, a more aggressive use of the Government's euro-currency portfolio has been undertaken, when comparative carrying cost advantages relative to US-dollar assets exist. Finally, the cost of holding securities has been further reduced by proceeds derived from the Government's active securities lending program.

Foreign Currency Assets and Liabilities (as of December 31, 2000)

	US\$ billions
Total assets*	28.9
Liabilities:	
Canada Bills	3.8
Canada Notes	0.6
Euro Medium-Term Notes	3.0
Global bonds	13.5
Cross-currency swaps	14.3
Total liabilities	35.3

Note: Numbers do not add due to rounding.

*Only liquid reserves are included (i.e. securities and deposits).

On the risk management side, a risk management framework has recently been put in place. Improved investment guidelines have been implemented, requiring that investments be permitted only in securities from issuers with a high minimum credit rating, and that the amount invested in each issue and category of issuer be capped in order to limit risks and ensure diversification. Collateralization is being introduced in 2001 to further enhance risk management.

In recent years foreign currency liabilities came to exceed liquid foreign currency assets in the Exchange Fund Account, largely as a result of extensive foreign exchange intervention and important commitments to the International Monetary Fund in 1998. At its widest point, the excess liability amounted to some US\$13 billion. Consistent with the Government's policy of immunizing currency and interest rate risk in Canada's reserve program, the Government is taking steps to bring foreign currency liabilities in line with foreign currency assets.

In December 1998 the Department of Finance, in collaboration with the Bank of Canada, implemented a program of purchases of US dollars in foreign exchange markets. These US dollars are used to reduce US-dollar-denominated liabilities. Purchases of US dollars are small in relation to the large daily flows in foreign exchange markets and are undertaken with sensitivity to market conditions. This program has reduced the gap between foreign currency assets and liabilities to some US\$6.5 billion as of the end of December 2000, and the plan is to close it over the next few years.

Funding Foreign Exchange Reserves

The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar discount note program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps have been a particularly cost-effective alternative to foreign-currency-denominated bond issues, and have been actively used in recent years. In 2000-01 cross-currency swaps of domestic obligations and purchases of US dollars have served as the primary sources of funding of the foreign exchange reserves program.

In addition to minimizing its funding costs by diversifying its funding sources, the Government aims to maintain a balanced profile of liability maturities to minimize rollover and financing risks. The general target is to ensure that foreign currency liabilities maturing in the next year do not exceed one-third of reserve assets; the Government has kept well within this target.

Sources of Foreign Exchange Reserves

(April 1 to December 31, 2000)

	US\$ billions
Sources of reserves:	
Purchases of US dollars	2.4
Cross-currency swaps	1.1
Public market borrowings	0.0
Total sources	3.5
Foreign exchange reserve requirements:	
Net maturing debt	(2.0)
Net foreign exchange debt charges	(0.5)
Government requirements and other	(0.2)
Requirements	(2.7)
Increase in foreign exchange reserves	0.8

Purchases of foreign exchange and the use of cross-currency swaps to fund reserves will be continued.

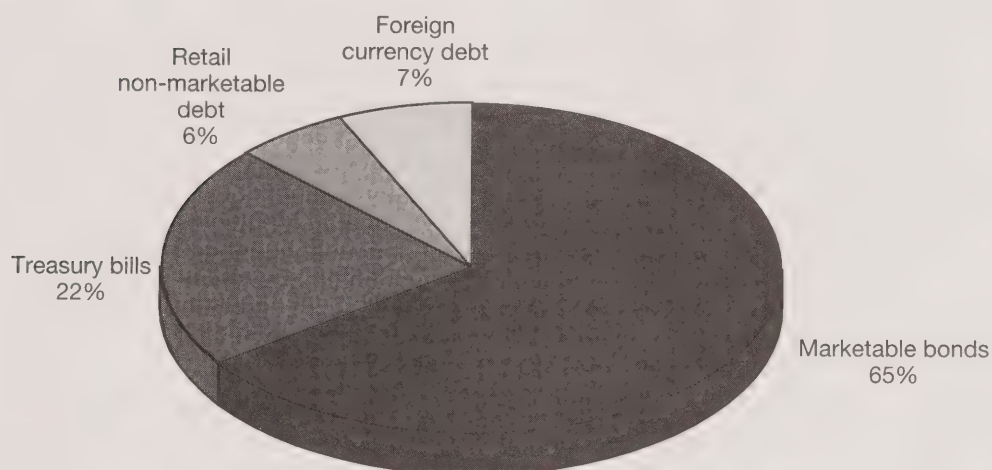
In 2001-02 the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations and purchases of US dollars will continue to be primary sources of reserve funding.

2001-02 Federal Debt Programs

Outlook for Market Debt

Over the coming years the composition of market debt is expected to remain largely unchanged. In 2001-02 debt programs are planned to operate at similar levels to the previous fiscal year.

Forecast Composition of Market Debt (March 31, 2001)



Note: Excluding bonds issued to the Canada Pension Plan.

2001-02 Federal Debt Program Plans

The federal debt management strategy for each debt program is presented on the next page. The strategy is based on the underlying fiscal policy of maintaining a balanced budget or better in 2001-02 and a projected financial requirement of \$3 billion. The federal debt program plan has been developed in consultation with market participants. The federal government will continue to consult with market participants in fiscal year 2001-02 on potential adjustments to maintain a well-functioning market in the changing debt management environment.

The federal government uses a variety of instruments to fund its domestic operations:

- Fixed-rate marketable bonds
- Real return bonds
- Treasury bills
- Retail non-marketable debt (primarily Canada Savings Bonds and Canada Premium Bonds)

The foreign currency borrowing program is used to fund Canada's foreign exchange reserves.

Fixed-Rate Marketable Bonds

Fixed-rate marketable Government of Canada bonds are issued in Canadian dollars and pay interest semi-annually. In 2001-02 about \$35 billion of bonds will be maturing.

The 2001-02 bond program (i.e. gross issuance), taking into account buyback operations and foreign funding activity, will be about \$40 billion on a gross basis.

Real Return Bonds

The target for real return bonds will be maintained.

As in 2000-01 the federal government plans to issue up to \$2 billion in real return bonds in 2001-02. In 2000-01, \$1.4 billion in real return bonds are being issued.

Treasury Bills

The Treasury bill program will operate at levels similar to those in 2000-01.

The Treasury bill stock varies over the year largely as a result of changes in the Government's funding and cash needs. In 2001-02, based on the fiscal plan in the budget, the stock at year-end is expected to be similar to the 2000-01 level.

Retail Debt

Retail debt is an important part of the Government's debt program.

Canada Investment and Savings (CI&S) contributes to the diversification of the investor base. The objective of the retail debt program is to provide cost-effective funding for the Government and to encourage Canadians to invest in Canada.

The retail debt plan will be released later in 2001 by CI&S.

Foreign Currency Debt Programs

Foreign funding activity will be spread across a range of funding sources.

It is expected that the principal sources of funding for the foreign exchange reserves will continue to be cross-currency swaps of domestic obligations and purchases of US dollars.

Glossary

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

bid: Price a buyer is ready to pay.

bid-offer spread: The difference between bid and offer prices. It is typically measured in basis points (hundredths of a per cent).

budgetary surplus: Occurs when government annual revenues exceed budgetary expenditures. A **deficit** is the shortfall between government revenues and budgetary spending.

Canada Bill: Promissory note denominated in US dollars, issued for terms of up to 270 days. Canada Bills are issued for foreign exchange reserve funding purposes only.

Canada Note: Promissory note usually denominated in US dollars and available in book-entry form. Notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada Notes are issued for foreign exchange reserve funding purposes only.

Canada Premium Bond: A savings product for individual Canadians introduced by the Government of Canada in 1998. It is offered for sale by most Canadian financial institutions, offers a higher interest rate compared to the Canada Savings Bond, and is redeemable once a year on the anniversary of the issue date or during the 30 days thereafter without penalty.

Canada Savings Bond: Is currently offered for sale by most Canadian financial institutions to individual Canadians. It pays a competitive rate of interest that is guaranteed for one or more years. It may be cashed at any time and, after the first three months, pays interest up to the end of the month prior to encashment.

CanPx: A transparency system which provides real time price and transaction information for key benchmark issues of Canadian government bonds and Treasury bills. Over time the system will be expanded to include other actively traded government securities.

contingency reserve: Is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and unpredictable events. The contingency reserve also provides an extra measure of backup against adverse errors in the economic forecast. If not needed, it is used to pay down the public debt.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting orderly conditions for the Canadian dollar in the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

financial balance (excluding foreign exchange transactions): Measures the difference between the cash coming in to the Government and the cash going out. In the case of a financial requirement, it is therefore the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-rate marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

foreign exchange reserves: Stocks of foreign exchange assets (e.g. interest-earning bonds) held by sovereign states to support the value of the domestic currency. Canada's foreign exchange reserves are held in a special account called the Exchange Fund Account.

government securities distributor: Member of a group of investment banks and dealers, through which the Government distributes Government of Canada Treasury bills and marketable bonds.

gross public debt: Total amount the Government owes. It consists both of market debt in the form of outstanding securities such as Treasury bills and Canada Savings Bonds, and internal debt owed mainly to the superannuation fund for government employees and other current liabilities.

hedge: A transaction intended to reduce the risk of loss from price fluctuations.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

interest rate swap: An agreement that exchanges one type of return for another (e.g. a fixed for a floating rate of interest) and also exchanges the principal amount for the term of the swap.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets, and includes marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds), foreign-currency-denominated bonds and bills, as well as bonds issued to the Canada Pension Plan.

marketable debt: A marketable debt instrument is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

market transparency: Within the context of debt management, characterization of a bond market where debt management strategies and operations are known and well understood by market participants.

net public debt: Consists of gross public debt net of financial assets.

non-market debt: Includes the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest and payment of matured debt).

offer: Price at which a seller is willing to sell.

primary market: Market for new issues of securities.

real return bond: A Government of Canada real return bond pays semi-annual interest based upon a real interest rate. Unlike standard fixed-rate marketable bonds, interest payments on real return bonds are adjusted for changes in the consumer price index.

secondary market: Market where securities are bought and sold after issuance.

sovereign market: Market for the debt issued by a government.

term structure of interest rates: The levels of interest rates from short- to long-term maturities.

tranche: A portion of a bond offering, delineated by maturity.

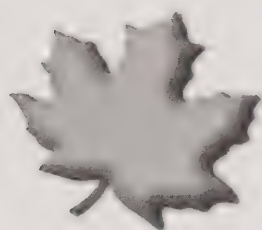
Treasury bill: A short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6 or 12 months are currently auctioned on a biweekly basis.

turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

yield curve: Graph based on the term structure of interest rates plotting the yield of all bonds of the same quality, with maturities ranging from the shortest to longest term available.

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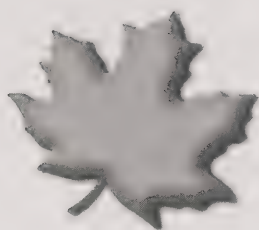


DEBT MANAGEMENT STRATEGY

2002-2003



Canada



DEBT MANAGEMENT STRATEGY

2002-2003



Department of Finance
Canada

Ministère des Finances
Canada

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Foreword by the Minister of Finance

I am pleased to table before Parliament the *Debt Management Strategy* of the Government of Canada for fiscal year 2002-03. It provides comprehensive information on the Government's debt management strategy in the coming fiscal year.

In keeping with its track record of sound fiscal management, the Government projected in December 2001 that the budget would be balanced or better in 2001-02 and in each of the two subsequent years. This would mean seven consecutive years of balanced budgets or surpluses.

From a peak of about 71 per cent in 1995-96, the debt-to-GDP (gross domestic product) ratio is expected to fall to below 50 per cent in 2002-03. This is important to all Canadians because, as the size of the debt declines relative to the size of the economy, the debt becomes more manageable. To that end, the Government has taken steps to reduce the debt not only in relation to the size of the economy but also in absolute terms, paying down \$36 billion in net debt in the last four years.

Still, the level of debt remains significant, with debt-servicing costs taking about 23 cents of each revenue dollar collected by the federal government. But this is a major improvement compared to the 36-cent debt-servicing cost in 1995-96.

While Canada is in the midst of a global economic slowdown – a slowdown made worse by the September 11, 2001, terrorist attacks on the United States – it is important to keep debt-servicing costs as low and as stable as possible. A crucial part of these efforts is the management of the Government's market debt.

The Honourable Paul Martin, P.C., M.P.
Minister of Finance
Ottawa, March 14, 2002

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance that provides information on the federal government's objectives and strategies for managing the outstanding stock of debt within the context of the fiscal environment.

The Government publishes a companion document, the *Debt Management Report*, which reports on the Government's debt operations over the previous fiscal year and provides detailed information on major strategic initiatives and on outstanding debt. This publication is available shortly after the release of the Public Accounts in the fall.

Highlights of the 2002-2003 Debt Strategy

- The Government is committed to balanced budgets or better in 2001-02 and in each of the next two fiscal years.
- Given the fiscal outlook, no restructuring of domestic debt programs is planned in 2002-03.
 - The target for the fixed-rate share of the debt will be maintained at two-thirds.
 - The Treasury bill program is planned to operate at levels similar to last year.
 - The gross issuance of bonds is planned to be similar to last year. The total amount of bonds issued through auctions is expected to be lower than last year, with the decline offset by new issuance through bond buybacks on a switch basis.
 - The bond program will continue to offer marketable bonds in four maturity sectors (2-, 5-, 10- and 30-year) and one bond that is inflation index-linked (30-year).
 - Current benchmark targets will be maintained for nominal bonds: 2-year (\$7 billion-\$10 billion), 5-year (\$9 billion-\$12 billion), and 10- and 30-year (\$12 billion-\$15 billion).
- Debt strategy initiatives aimed at enhancing the Government of Canada securities market include the following:
 - The processing time for auctions and bond buyback operations will be further reduced as the year progresses to lower market risk for participants and promote participation.
 - Bond issues that are targeted in buyback operations will be expanded to include some older benchmark bonds. A larger ceiling for individual buyback operations will be adopted to improve the effectiveness of the bond buyback program.
 - The pilot cash management bond buyback program, introduced in 2001-02 to smooth the Government's cash requirements, will continue in 2002-03.
 - Work will continue with market participants and regulators to enhance market integrity, transparency, liquidity and efficiency.
 - Collateral-based frameworks will be implemented for domestic cash balances, cross-currency swaps and foreign cash balances to ensure prudent management of counterparty risk.

Debt Management Framework

Debt Management Objectives

The fundamental debt management objective is to raise stable, low-cost funding for the Government. A key strategic objective is to maintain a well-functioning market for Government of Canada securities. A well-functioning market contributes to keeping costs low and benefits financial markets in general.

Debt Management Principles

In the pursuit of these objectives, the Government abides by the following operational principles.

- Prudence: Raise all the required funding for its operational needs in the domestic market. Manage the composition of the domestic debt to protect the Government's fiscal position from unexpected increases in interest rates and to limit refinancing needs in any given period. Minimize, to the extent possible, risks arising in the management of the Government's foreign reserves portfolio.
- Transparency, liquidity and regularity: Emphasize transparency, liquidity and regularity in the design and implementation of its domestic debt programs in order to maintain a well-functioning domestic market and keep costs low.
- Diversification: Borrow using a variety of instruments and range of maturities to keep costs low and maintain a diversified investor base.
- Market integrity: Work with market participants and regulators to enhance the integrity and attractiveness of Government of Canada securities to investors.
- Consultations: Actively seek input from market participants on major adjustments to the federal debt and cash management programs.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

The fundamental debt management objective is to provide stable, low-cost funding for the Government.

Debt management operations are planned and executed in keeping with a number of key principles.

Debt Management General Strategy

The general approach taken by the Government to achieve the debt management objectives is as follows.

Domestic Market

The Government borrows strategically in domestic markets.

- The Government structures the maturity profile of the debt in a way that balances lower financing costs with reasonable cost stability and lower refinancing risk under a range of potential interest rate environments over the long term. The target debt structure is not based on a particular interest rate outlook.
- To enhance the functioning of the market, the Government borrows on a regular, pre-announced basis in key segments of the market, builds large bond benchmarks and maintains effective rules for participation at Government of Canada securities auctions.
- The Government maintains a diversified investor base by auctioning nominal bonds, real return bonds and Treasury bills in the wholesale market and by selling savings products to Canadians in the retail market.

Foreign Currency

The Government operates on a discretionary basis in managing the foreign reserves portfolio.

- The Government finances foreign exchange reserves through a range of programs, the use of which is determined by asset portfolio objectives, cost, maturity profile and market conditions.
- Foreign liabilities are matched with reserve assets to limit currency and interest rate risks.
- The Government funds its foreign exchange debt through diverse sources and structures the maturity of the debt to limit refinancing needs.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government projects balanced budgets or better for 2001-02 and for each of the next two fiscal years.

The Government's fiscal policy sets the context for debt management operations. The Government has recorded budgetary surpluses over the past four fiscal years and has paid down \$35.8 billion of the net public debt. Taking into account the economic slowdown and initiatives announced in the 2001 budget, the Government is committed to maintaining balanced budgets or better for 2001-02 and for each of the next two fiscal years.

Contingency Planning in the Current Environment

The Government sets aside an annual Contingency Reserve to cover risks arising from unpredictable events and variations in economic forecasting.

The unforeseen circumstances of both the slowdown in the global economy and the September 11th terrorist attacks created a high degree of uncertainty and exceptional fiscal pressures. In this regard, the Government announced in the December 2001 Budget that it plans to use a portion of the Contingency Reserve.

■ The Contingency Reserve is set at \$1.5 billion for 2001-02, rising to \$2.0 billion in 2002-03 and \$2.5 billion in 2003-04.

■ The Government intends to restore the level of the Contingency Reserve as soon as possible.

The Contingency Reserve for 2001-02 will be used for debt paydown. For 2002-03 and 2003-04 the Government plans to use the Contingency Reserve, to the extent that it is not needed to meet unexpected circumstances, to pay down the debt as well.

Combined with forecast economic growth, the debt-to-GDP ratio – the level of debt in relation to the country's annual income – remains on a downward track. From a peak of 70.7 per cent in 1995-96, the ratio is expected to fall to under 50 per cent in 2002-03 – the lowest ratio in 17 years – and to about 47 per cent by 2003-04.

The measure used for debt management planning is the Government's financial balance.

The net financial balance is affected by foreign exchange transactions.

Financial Balance (Excluding Foreign Exchange Transactions)

The key budgetary measure for debt management planning is the financial balance – requirement or source – rather than the budgetary balance (see box below). The budgetary balance is presented on a modified accrual basis, recognizing liabilities when they are incurred rather than when they are actually paid out. In contrast, the financial balance is on a cash basis.

Foreign Exchange Transactions

In the past several years foreign exchange transactions, which were used to build up Canada's foreign exchange reserves, have reduced the size of net financial balances. In 2002-03 the level of Canada's foreign exchange reserves is expected to remain largely unchanged, although a modest financing requirement may be engendered by transactions related to Canada's commitment to the International Monetary Fund (IMF).

Measuring the Government's Fiscal Position: Budgetary Balance and Financial Balance

The budgetary balance and financial balance are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

The budgetary balance – deficit or surplus – is one measure of the Government's fiscal situation. It is presented on a modified accrual basis of accounting, recording liabilities when they are incurred, regardless of when the actual cash payment is made.

The financial balance – requirement or source – provides a measure of the net cash position needed to fund the Government's programs and debt charges. The budgetary balance includes obligations incurred by the Government during the course of the year, whereas the financial balance includes only the cash outlay related to these obligations.

The net financial balance includes foreign exchange transactions, which represent all transactions in international reserves held in the Exchange Fund Account and commitments to the IMF. The net financial balance corresponds closely to the unified budget balance measure used in the United States.

Transactions for the Year Ending March 31, 2001

(in millions of dollars)

Budgetary surplus \$17,148	
+	
Non-budgetary transactions \$1,843	Loans, investments and advances, pensions and other accounts, and other transactions
=	
Financial source \$18,991	
-	
Foreign exchange transactions \$8,776	Foreign exchange reserves, IMF subscription and allocations
=	
Net financial source \$10,215	

Source: *Public Accounts of Canada*, 2000-01.

Market Debt Outlook

*The outlook
is for some
modest market
debt retirement
in 2002-03.*

The net public debt has declined by \$35.8 billion over the past four fiscal years, including a \$30.5-billion decline in market debt. A small financial source is currently foreseen for 2002-03. A net financial source is uncertain as it is affected by foreign exchange transactions occurring during the year. At this time the outlook is for some modest market debt retirement in 2002-03.

The Government does not expect to borrow net new funds in 2002-03. If necessary, it can draw on the existing amount of \$4 billion in non-lapsing borrowing authority provided by the 1996-97 Borrowing Authority Act.

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained in the form of a borrowing authority bill to raise net new debt.

Currently available new borrowing authority is limited to a \$4-billion non-lapsing contingency provided by the 1996-97 Borrowing Authority Act.

Only the market debt component of the gross public debt is actively managed.

Debt Composition

Debt management operations focus on market debt, which is only one component of the gross public debt, and financial assets. The other component of the gross debt, non-market debt, is taken into account in debt strategy planning but is not actively managed. Non-market debt generally includes federal public sector pension liabilities and the Government's accrued liabilities. The chart below illustrates the relationships between the components of the public debt.

Total Public Debt as of March 31, 2001 (in millions of dollars)

Market debt \$446,403	← Marketable bonds, Treasury bills, Canada Savings Bonds and Canada Premium Bonds, real return bonds, foreign debt
+	
Non-market debt \$186,473	← Pensions and other accounts, other liabilities
=	
Gross public debt \$632,876	
-	
Financial assets \$85,498	← Cash, foreign exchange reserves, loans, investments and advances
=	
Net public debt \$547,378	

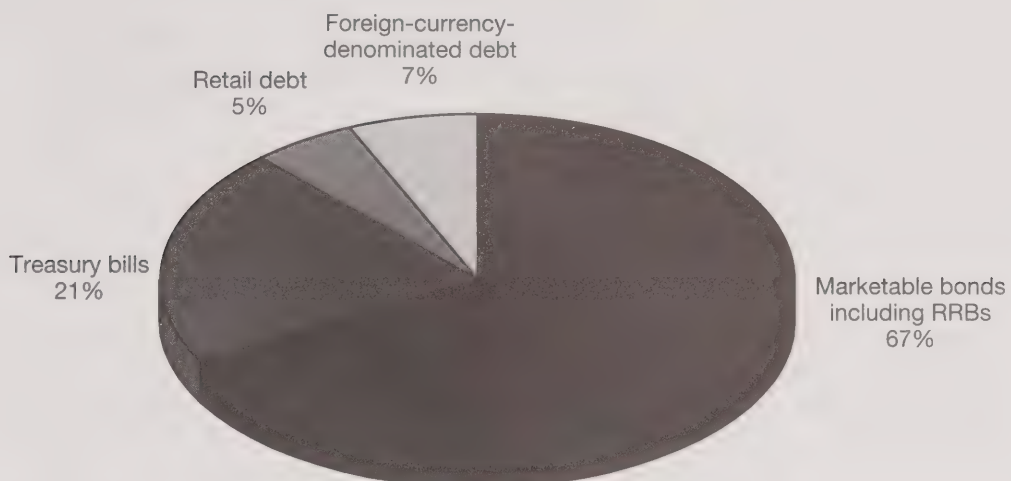
Source: *Public Accounts of Canada*, 2000-01.

The composition of market debt is expected to remain largely unchanged in 2002-03.

The federal government's market debt consists mainly of fixed-rate marketable bonds, real return bonds (RRBs), Treasury bills, retail non-marketable debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt. Financial assets held by the Government include operating cash balances, loans and investments, and foreign exchange reserves.

Over the coming year the composition of market debt is expected to remain largely unchanged. Debt programs are planned to operate at similar levels to the 2001-02 fiscal year. The chart on the next page shows the forecast composition of federal market debt at the end of the 2001-02 fiscal year.

Forecast Composition of Market Debt, March 31, 2002



Note: Excludes bonds issued to the Canada Pension Plan.
Source: Department of Finance.

2002-2003 Debt Management Strategy

Key Considerations

Maintaining a Prudent Debt Structure

Prudence remains important given the outstanding debt stock.

Canada's outstanding stock of market debt, which stood at \$446 billion as of March 31, 2001, is exposed to interest rate changes originating in Canada and around the world. Interest rate changes can significantly affect annual debt charges, as the portion of debt that matures must be reissued at the new prevailing market interest rates. Including multiple refinancings of maturing short-term Treasury bills, some \$324 billion of the federal market debt will be maturing or repriced over the 2002-03 fiscal year.¹

The Government takes a long-term perspective with respect to the debt structure.

In determining the composition and maturity profile of the debt, the Government takes a long-term perspective with respect to the trade-off between the cost and risk of issuing various forms of debt. The trade-off reflects the fact that, from a borrower's point of view, longer-term debt instruments are generally more costly but less risky than shorter-term debt instruments.

The key operational measure of the debt structure is the fixed-rate portion of debt.

The primary measure of the debt structure is the fixed-rate share, which is the proportion of interest-bearing debt having fixed rates (debt that does not mature or need to be re-priced within a year). Consideration is also given to the debt structure's average term to maturity, or average length of time before debt instruments need re-pricing.

Target Fixed-Rate Share

The Government has achieved greater debt cost stability over the past several years by increasing the fixed-rate target from about 50 per cent to the current target of two-thirds. Over the past three fiscal years the fixed portion of debt has remained around the two-thirds level, although small fluctuations occur as operations are conducted throughout the year.

The fixed-rate target is reviewed annually.

As part of debt strategy planning, the fixed-rate debt structure target is reviewed annually to assess its suitability given changes in the fiscal and economic environment. Factors that influence the decision on the target structure are the short-term volatility of debt costs (given the interest rate environment), the structure's impact on borrowing requirements, and the long-term cost/risk profile.

For 2002-03 the target fixed-rate share of the debt will remain at two-thirds.

Based on the analysis of costs and risks, the Government will maintain the target fixed-rate share of the debt at two-thirds for 2002-03. The Government will continue to evaluate the fixed-rate debt structure target needed to balance the long-term cost/risk profile against short-term fiscal and economic constraints. In this regard, work is ongoing to assess the costs and risks of alternative fixed-rate debt structures.

¹ Includes cross-currency swaps. By comparison, the amount maturing or repriced excluding cross-currency swaps is \$276 billion, modestly higher than in 2001-02 (\$262 billion).

2002-2003 Analysis of Fixed-Rate Debt Structures

The analysis of the target debt structure compares the expected debt costs and debt cost variability of the current fixed-rate debt structure to debt structures that have ± 5 percentage points fixed-rate shares.

The comparison of alternative fixed-rate debt structures indicates that debt costs would likely be about \$600 million higher next year if the fixed-rate portion of debt were 5 percentage points higher (72 per cent) while debt costs would likely be about \$400 million lower next year if the fixed-rate portion of debt were 5 percentage points lower (62 per cent) (see chart on next page). By comparison, last year's analysis indicated that debt costs would likely be about \$100 million higher (lower) with a 72-per-cent (62-per-cent) fixed-rate share. Last year's values were lower because the yield curve was very flat compared to the historical yield curve shape. Compared to last year, there is currently a greater differential between short- and long-term rates.

The above comparative analysis is indicative of higher and lower cost/risk profiles that could only be achieved over time. The differences in debt costs depend on the yield curve, which is likely to be different when the debt is actually refinanced. For example, if a change were made next year to a 2-percentage-point lower (or higher) fixed-rate structure, debt costs would be about \$100 million lower (higher).

The fixed-rate share of debt affects not only debt costs but also the volatility of debt costs. Cost at Risk (CaR) analysis,² which quantifies the debt cost risk under a particular fixed-rate debt structure, suggests that, over a long-term horizon, the costs and risks of alternative debt structures within the range of 62 per cent to 67 per cent are fairly similar. Over time the expected debt cost savings with a lower fixed-rate structure would offset the potential volatility in debt costs due to interest rate risk and offer some prospect for overall lower debt costs.

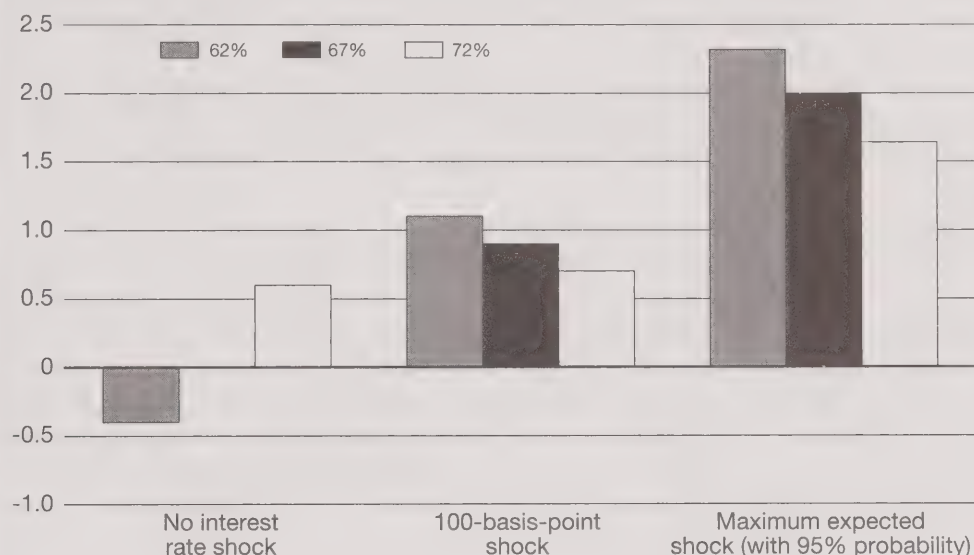
This result needs to be interpreted with care, however, as the impact of extreme interest rate shocks is not considered in the CaR analysis and remains a factor in the prudent debt structure decision. Under worst-case scenarios of significantly greater interest rate shocks, the impact on debt costs under lower fixed-rate structures could disrupt the fiscal plan.

² A more detailed description of the analytical measures used to determine the debt structure target is contained in *Debt Management Report 2000-2001*, which is available on the Department of Finance Web site at www.fin.gc.ca.

A prudent debt structure ensures that the Government's exposure to a variety of interest rate shocks in the short term is confined to tolerance levels in keeping with the current fiscal plan. CaR analysis indicates that the two-thirds fixed-rate structure is highly likely to limit the fiscal impact of unanticipated increases in interest rates to \$2 billion or less over the next year (see chart below).

Debt Cost Sensitivity to Interest Rate Shocks

(in billions of dollars)



Note: Values represent the estimated deviation from expected debt costs with a two-thirds fixed-rate structure.
Source: Department of Finance.

With the two-thirds fixed-rate structure, a 100-basis-point increase in interest rates would now raise net debt-servicing costs by \$0.9 billion next year; by comparison, the impact of the same interest rate shock was estimated at \$1.8 billion in the mid-1990s with a one-half fixed-rate structure.

With the two-thirds debt structure, the Government also limits the need to refinance a large portion of debt in any given period. In 2002-03 the Government is expected to refinance, on average, \$4 billion per week in maturing Treasury bills compared to \$7 billion per week in the mid-1990s, when the fixed-rate portion of debt was one-half.

Average Term to Maturity

The average term to maturity of the debt has been increasing.

Average term to maturity (ATM), measured in years, represents the average length of time before debt instruments mature and are subject to refinancing risk. The ATM of marketable debt has increased from roughly 4 years in 1990 to 6.4 years in March 2001. The upward trend in ATM resulted from the increase in the fixed-rate share, the reduction in the stock of Treasury bills, and the continued issuance pattern of marketable bonds that includes 30-year bonds (the first 30-year bond issue, sold in 1990, will not mature until 2021).

While the fixed-rate share has remained relatively constant over the past three years, the ATM of the debt is projected to increase to roughly 6.6 years at the end of March 2002 given the current issuance pattern of the Government of Canada bond program.

The costs and operational implications of changing the ATM will be evaluated.

Further analytical work on the composition of the fixed-rate portion of the debt will be done in 2002-03, in particular on the costs and operational implications of changes in the market debt's ATM.

Maintaining a Well-Functioning Market

Maintaining a well-functioning market for Government of Canada securities is a key objective of the debt strategy.

For over a decade federal debt strategy has placed great emphasis on the development of a well-functioning Government of Canada securities market. As a major sovereign country and frequent borrower, the Government must employ regular and transparent programs that sustain a liquid and efficient market. A well-functioning market attracts broad investor interest, which helps to provide stable, low-cost financing over time. A liquid and efficient Government of Canada securities market also provides key pricing and hedging tools for market participants and thereby contributes to the health of the broader fixed-income market.

The Government monitors turnover and bid-offer spreads as key indicators of the status of the market, as well as best practices. In these respects, recent studies indicate that Canada compares favourably with other major sovereigns. However, in the recent environment of limited borrowing requirements and a declining debt stock, developing and testing initiatives to maintain and enhance market liquidity remains a key focus of the Government's debt strategy.

In 2002-03 a number of operational initiatives will be undertaken to enhance liquidity and activity in Government of Canada securities (see the next section for details). Among other things, participation in buybacks will be encouraged by increasing the range of securities involved and the use of a pilot program of buybacks on a switch basis. These adjustments will assist in converting less liquid outstanding securities for new liquid bond benchmarks and help to build target bond benchmarks more quickly.

The market risk borne by auction and buyback participants will be reduced by moving to shorter operational turnaround times. In addition, transparency will be enhanced through regular market consultations on the development of debt policies and programs, with reports on topics of interest and views received posted on the Bank of Canada's Web site at www.bankofcanada.ca.

2002-2003 Debt Strategy Plan

Domestic Debt Programs

No major restructuring of domestic debt programs is planned in 2002-03.

Domestic debt programs are expected to operate at similar levels to those of 2001-02, and no restructuring is planned in 2002-03. In developing the debt program plans below, the Government has conducted extensive consultations with market participants in recent months. A report on these consultations, and others conducted earlier in 2001-02, is available on the Bank of Canada Web site at www.bankofcanada.ca. The Government will continue to consult with market participants during fiscal year 2002-03 on potential adjustments to program plans.

Fixed-Rate Marketable Bond Program

In 2002-03 some \$35 billion of bonds will be maturing. Gross bond program issuance in 2002-03 will be about \$40 billion, taking into account the issuance of new bonds that are exchanged for existing bonds under the pilot program of buybacks on a switch basis.

Thirty-year bond issuance will continue.

Consultations have indicated that market participants strongly favour continued issuance of 30-year bonds. From the Government's perspective, these securities play an important role in the stability of the Government's debt portfolio. Accordingly, the domestic bond program will continue to have four benchmark maturities (2-, 5-, 10- and 30-year) with benchmark target sizes unchanged from last year (2-year bonds: \$7 billion to \$10 billion; 5-year bonds: \$9 billion to \$12 billion; 10- and 30-year bonds: \$12 billion to \$15 billion). The benchmark sizes will be achieved through reopenings where a particular bond issue is sold at several auctions until the benchmark target range is reached.

Benchmark bond size targets will remain unchanged.

A regular, transparent calendar of auctions will be maintained. In 2002-03 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds. The Bank of Canada will announce the quarterly auction calendar shortly before the start of each quarter.

Auction and buyback turnaround time will be reduced.

The process time for bond auctions will be reduced as the year progresses to lower market risk for participants. The auction turnaround time is planned to be lowered from 15 minutes to 10 minutes as the year progresses. The process time for bond buyback operations will be reduced from 30 minutes to 15 minutes.

Bond Buyback Program

The objective of the existing bond buyback program is to permit the maintenance of a liquid new bond issue program. The program targets older, less liquid bonds for repurchase. Transactions are conducted in conjunction with auctions of similar maturity bonds.

Pilot bond buybacks on a switch basis will accompany the ongoing buybacks on a cash basis.

In December 2001, following consultations with market participants, the Government announced that it would pilot buyback operations on a switch basis to broaden participation. Buyback operations on a switch basis involve the exchange of existing, less liquid bonds for new-issue bonds on a duration-neutral basis; that is, the bondholder can switch an off-the-run bond for the current benchmark issue with no impact on portfolio structure. The first switch operation was recently held in the 30-year sector.

With the introduction of buybacks on a switch basis, bond buyback volumes will be larger.

The Government intends to conduct both cash and switch buyback operations in 2002-03 on a larger scale than in 2001-02, taking into account the pilot switch program. The target size of the bond buyback programs and the timing of operations will be announced through the quarterly bond auction calendar published by the Bank of Canada.

During consultations the Government sought the views of market participants on adding flexibility to buyback activity, including expanding the bond buyback basket and allowing the Government to buy back a larger amount of bonds should market conditions be favourable.

Bond issues included in buyback operations will include some older benchmark bonds and their fungibles.

In 2002-03 the buyback basket will be expanded to include some older benchmark bonds and their fungibles. Bonds that will continue to be excluded from buybacks include issues in the 2-, 5- and 10-year sectors that are currently being built as a benchmark, the current and preceding benchmark, as well as those having maturities greater than or equal to 25 years. The decision on specific bond issues to be included in buyback operations will take into account the views of market participants and will continue to be announced with the Call for Tender.

The ceiling for individual operations will be increased.

The announced ceiling for individual buyback operations will be raised from 2001-02 levels, and will continue to represent the maximum amount of bonds that the Government would buy back during that operation. The increase in the ceiling will permit the Government to take advantage of favourable buyback opportunities, depending on financial requirements at the time and prevailing price levels. On most occasions it is expected that the amount purchased by the Government will be lower than the announced ceiling.

The auction schedule is available on the Bank of Canada's Web site at www.bankofcanada.ca. A list of outstanding Government of Canada bonds, including maturity dates, can be found in *Debt Management Report 2000-2001*, which is available on the Department of Finance Web site at www.fin.gc.ca. A list is also available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will also be available on the Bank of Canada's Web site.

Real Return Bonds

RRB issuance will continue.

In 2002-03 the federal government plans to issue about \$1.4 billion of RRBs through quarterly uniform price auctions.

Retail Debt Program

The retail debt program will focus on balancing cost-effectiveness and innovation.

In 2002-03 the Government will focus on balancing the need to be cost-effective in an environment of declining retail stock with investments in innovation required to maintain a vibrant and creative Retail Debt Program.

Targeted initiatives aimed at broadening access and diversifying the investor base, including on-line access, direct sales and a focus on youth, will be continued and in some cases expanded in the upcoming year. As well, more cost-effective and flexible means of delivering systems and operations support services will be actively pursued.

A separate Retail Debt Plan will not be released in 2002-03 by Canada Investment and Savings, the Government's retail debt agency, but specific initiatives that are developed will be announced at the appropriate time.

Treasury Bill Program

The Treasury bill program is expected to operate at similar levels to last year.

The Treasury bill stock varies over the year largely as a result of changes in the Government's funding and cash needs. Based on funding needs indicated in the 2001 budget, the Treasury bill program is expected to operate at similar levels to 2001-02. The stock of Treasury bills at the end of fiscal year 2002-03 is expected to be in the range of \$90 billion to \$100 billion.

Bond Buybacks for Cash Management

The pilot cash management bond buyback program will be continued in 2002-03.

To help in smoothing the Government's cash requirements, a pilot program of cash management bond buybacks was implemented in 2000-01. The purpose of the program is to reduce the peak levels of government cash balances needed to redeem upcoming large bond maturities.

The program currently involves buying back bonds with less than 12 months to maturity. The pilot program will be continued in 2002-03, as operational parameters and effectiveness are assessed and potentially adjusted.

Primary Market Enhancements

Consultations on debt management operations will continue.

Market participants will continue to be consulted on ways of enhancing debt program operations. Through this approach, the Government seeks to maintain a high standard of transparency, to improve operational flexibility and to obtain external input into its decisions on debt management operations. Communications will be conducted through notices and information posted on the Bank of Canada's Web site (www.bankofcanada.ca).

Domestic Market Initiatives and Integrity

The Government has a strong interest in ensuring the well functioning and integrity of the market for fixed-income securities, particularly Government of Canada securities, which are the benchmark of the market.

Discussions with market participants and securities regulators on enhancing market transparency and integrity are ongoing.

The Department of Finance and the Bank of Canada have an ongoing dialogue with the Canadian Securities Administrators and market participants on the regulation of electronic trading and the appropriate framework for the regulation of the domestic fixed-income market.

In this context, the Government supports the enhancement of transparency mechanisms. A current initiative is the proposed use of the CanPx system as the consolidator for information on fixed-income securities trading across various marketplaces. CanPx is a screen-based, real-time information system that provides market participants with best bid and offer prices and trading volumes, conducted on inter-dealer broker screens, in a range of benchmark fixed-income securities.

Management of the Government's Cash Balances

The Government manages its cash balances in order to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. Under the current framework the cash balances are placed with participants of the Large Value Transfer System as uncollateralized deposits through a competitive auction process.

The Government is implementing a cash management framework in 2002-03 to reduce credit risk.

The Government has developed a new credit framework for investing the cash balances.³ The new framework will be implemented in mid-2002-03 and is in line with the best practices of other governments and market participants. The two key modifications to the framework are the introduction of a credit management system, using credit ratings, credit lines and collateral to better manage credit risk, and a broadening of the list of eligible counterparties to encourage more competitive bidding at auctions.

Foreign Debt Programs

Foreign Exchange Debt and Reserve Assets

The Government holds foreign exchange reserves for liquidity and intervention purposes.

The Government's foreign exchange reserve assets, held in the Exchange Fund Account, provide the Government with foreign currency liquidity and may be used for intervention in the foreign exchange markets to promote orderly conditions for the Canadian dollar. Further details on the management of international reserves are available in the *Exchange Fund Account Annual Report*, available on the Department of Finance Web site at www.fin.gc.ca.

The Government's foreign currency reserves are funded through foreign currency borrowings. The foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis, based on many of the same principles used by private sector financial institutions, including prudent risk management principles.

The key objectives of the reserves program are:

- ensure that an appropriate level of reserves is maintained while minimizing the cost of carrying reserves (i.e. the difference between interest earned on reserve assets and interest paid on foreign currency liabilities);
- immunize to the extent possible currency and interest rate risk by selecting reserve assets that match the liabilities in currency and duration; and
- maintain diversified funding sources and a prudent liability structure to help manage refinancing needs.

³ A detailed description of the cash management investment framework is contained in *Debt Management Report 2000-2001*, which is available on the Department of Finance Web site at www.fin.gc.ca.

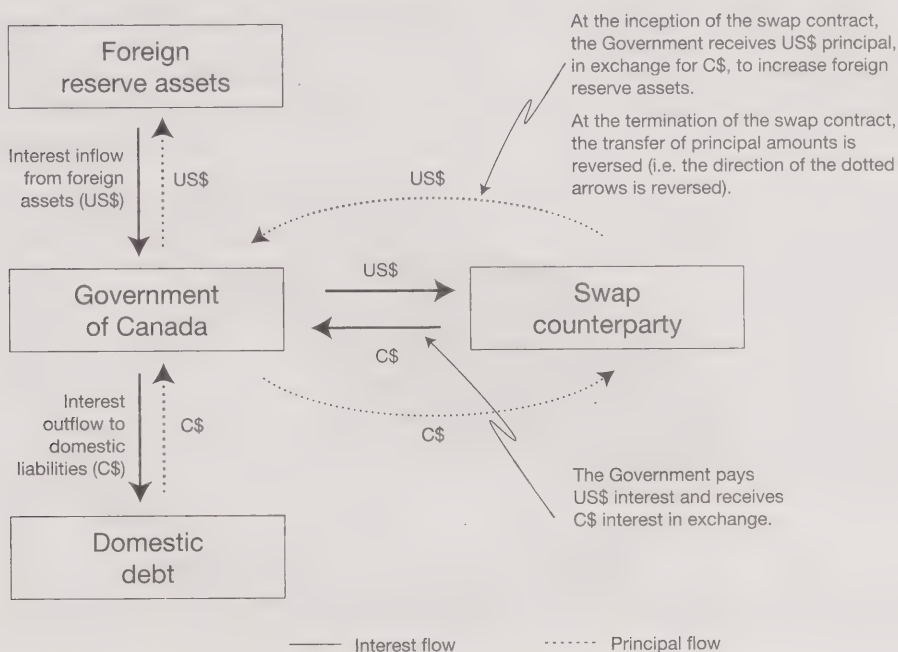
Funding Sources

The Government has access to a wide range of sources to fund its foreign currency assets.

The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar discount note program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps, which have proven to be a particularly cost-effective alternative, have been actively used in recent years.

Consistent with the Government's policy of immunizing currency and interest rate risk in Canada's reserve program, the Government occasionally purchases US dollars to meet international and other operational requirements and to bring foreign currency liabilities in line with foreign currency assets.

Cross-Currency Swap Contract to Raise Foreign Exchange Reserves



Note: This diagram is only a schematic representation of the currency flows associated with US\$ cross-currency swaps.

Source: Department of Finance.

In 2002-03 the precise mix of funding sources will depend on a number of considerations.

In 2002-03 the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations and purchases of US dollars will continue to be primary sources of reserve funding.

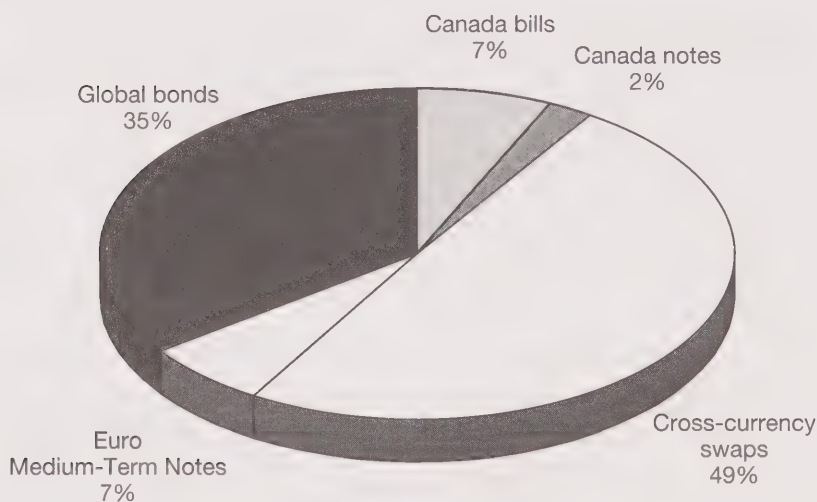
Credit Risk Management

In 2002-03 the Government will proceed to implement of a collateral management framework to better manage credit risk.

The Government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. The Government's risk management policies call for prudent management of treasury risks based on best practices. Standards for risk tolerance are very prudent, with market risks generally immunized and high credit quality and diversification standards followed.

In 2002-03 the Government will be proceeding with the implementation of a collateral management framework to better manage the Government's credit risk to its financial institution counterparties associated with all Exchange Fund Account business, in particular cross-currency swaps and US-dollar short-term cash investments.

**Forecast Composition of Foreign Currency Liabilities,
March 31, 2002**



Source: Department of Finance.

Glossary

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

bid: Price a buyer is ready to pay.

bid-offer spread: The difference between bid and offer prices. It is typically measured in basis points (one hundredth of a per cent).

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenditures. A **deficit** is the shortfall between government revenues and budgetary expenditures.

Canada bill: Promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Notes can be issued for terms of nine months or longer and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserve funding purposes only.

Canada Premium Bond (CPB): Introduced by the Government of Canada in 1998, CPBs are savings products for individual Canadians. They are offered for sale by most Canadian financial institutions and offer a higher interest rate compared to CSBs. They are redeemable once a year on the anniversary of the issue date or during the 30 days thereafter without penalty.

Canada Savings Bond (CSB): CSBs are currently offered for sale by most Canadian financial institutions to individual Canadians. CSBs pay a competitive rate of interest that is guaranteed for one or more years. They may be cashed at any time and, after the first three months, pay interest up to the end of the month prior to encashment.

CanPx: A screen-based, real-time information system that provides market participants with best bid and offer prices and trading volumes in a range of benchmark fixed-income securities.

Contingency Reserve: Funds set aside in the fiscal projections to cushion against changes in the economy. When these reserves are not otherwise used they are applied to the federal debt.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

Exchange Fund Account: A fund maintained by the Government of Canada to provide foreign currency liquidity and promote orderly conditions for the Canadian dollar in the foreign exchange market.

financial balance (excluding foreign exchange transactions): Measures the difference between cash coming in to the Government and cash going out. In the case of a financial requirement, it is therefore the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fixed-rate marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

government securities distributor (GSD): GSDs are members of a group of investment banks and dealers, through which the Government distributes Government of Canada Treasury bills and marketable bonds.

gross public debt: Total amount the Government owes. It consists of both market debt and internal debt owed mainly to the superannuation fund for government employees and other current liabilities.

interest-bearing debt: Consists of unmaturing debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

marketable debt: A marketable debt instrument is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets. It includes marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds), foreign-currency-denominated bonds and bills, as well as bonds issued to the Canada Pension Plan.

market transparency: Within the context of debt management, characterization of a bond market where debt management strategies and operations are known and well understood by market participants.

net public debt: Consists of gross public debt net of financial assets.

non-market debt: Includes the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest and payment of matured debt).

offer: Price at which a seller is willing to sell.

primary market: Market for new issues of securities.

real return bond (RRB): Government of Canada RRBs pay semi-annual interest based on a real interest rate. Unlike standard fixed-rate marketable bonds, interest payments on RRBs are adjusted for changes in the consumer price index.

secondary market: Market where securities are bought and sold after issuance.

sovereign market: Market for the debt issued by a government.

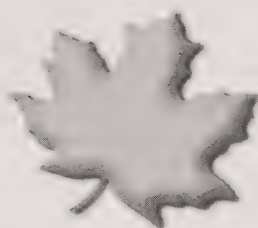
swap: An agreement that exchanges one type of return for another (e.g. a fixed for a floating rate of interest) and also exchanges the principal amount for the term of the swap.

tranche: A portion of a Treasury bill or bond offering, delineated by maturity.

Treasury bill: Short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6 or 12 months are currently auctioned on a biweekly basis.

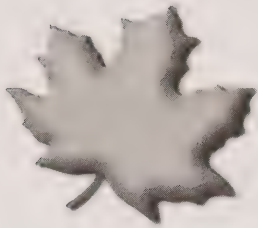
turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

yield curve: Graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.



DEBT MANAGEMENT STRATEGY

2003–2004



DEBT MANAGEMENT STRATEGY

2003–2004



Department of Finance
Canada

Ministère des Finances
Canada



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Foreword by the Minister of Finance

I am pleased to table before Parliament the *Debt Management Strategy* of the Government of Canada for fiscal year 2003–04. This document outlines the Government's debt objectives and strategy in the coming fiscal year.

Canada's commitment to prudent financial management is paying off. The Government has reduced the debt in each of the past five years for a total of \$47.6 billion. The Government has recently presented its sixth balanced budget and is committed to balanced budgets in each of the next two fiscal years. The federal debt-to-GDP (gross domestic product) ratio decreased from 67.5 per cent in 1995–96 to 46.5 per cent in 2001–02. With continued economic growth, the debt burden is expected to fall to about 40 per cent in 2004–05. According to the Organisation for Economic Co-operation and Development, the total government debt burden in Canada is expected to be second best among Group of Seven (G-7) countries by 2004. This is a substantial improvement on an absolute basis from our standing of second worst in 1995.

Our improved macroeconomic environment, including low and stable inflation and interest rates, will enable the Government of Canada to reduce the share of debt issued at fixed rates to achieve debt cost savings that can be used to meet the priorities of Canadians.

Lower debt costs are the dividends of Canada's fiscal and economic progress. However, the country's debt still remains substantial and it will continue to be prudently structured with the majority in fixed-rate form. Maintaining a balanced and prudent approach to the management of the country's finances will help ensure that Canada maintains its status as a world-leading economy.

The Honourable John Manley, P.C., M.P.
Deputy Prime Minister and Minister of Finance
Ottawa, March 21, 2003

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance that provides information on the Government of Canada's objectives and strategies for managing the outstanding stock of debt within the context of the fiscal environment.

The Government publishes a companion document, the *Debt Management Report*, which reports on the Government's debt operations over the previous fiscal year and provides detailed information on outstanding debt. This publication is available shortly after the release of the Public Accounts in the fall.

Highlights of the 2003–2004 Debt Strategy

- As announced in the February 2003 budget, the target for the fixed-rate share of the debt will be reduced from two-thirds to 60 per cent over the next five years to achieve debt cost savings, while retaining a prudent debt structure.
- To maintain a well-functioning market in Government of Canada securities, the change in the debt structure will be made gradually through increases in the Treasury bill program and reductions in the bond program. The Government will continue to consult with market participants at regular intervals.
- In 2003–04, the move towards a lower fixed-rate debt structure will involve the following:
 - The size of the Treasury bill program will increase from about \$105 billion to a level of approximately \$120 billion by the end of 2003–04.
 - The total amount of marketable bonds issued in 2003–04 will be about \$40 billion, similar to 2002–03. Net bond issuance of about \$30 billion will also be similar to 2002–03.
 - The planned amount of bond buybacks is in the order of \$13 billion, similar to 2002–03. Switch buybacks will be modestly increased and cash buybacks slightly reduced.
 - The bond stock will decrease from approximately \$265 billion to \$255 billion due to maturities and continued cash management bond buyback operations.
 - The 10-year bond benchmark will be lowered from \$12 billion–\$15 billion to \$10 billion–\$14 billion, to allow the maintenance of an annual 10-year benchmark cycle.
 - For cash management purposes, the auction size of 2-year bonds may be reduced from \$3.5 billion to as low as \$2.5 billion when the benchmark is fungible with a large outstanding bond.
 - Treasury bill auctions will be moved from 12:30 p.m. to 10:30 a.m. on a trial basis, as suggested by market participants. Cash management bond buyback operations will follow Treasury bill auctions.

Debt and Cash Management Framework

Effective management of the federal debt is important to all Canadians as the annual debt-servicing cost is the largest single spending program of the federal government. The federal debt management framework is an important component of the Government's objective of maintaining a fiscal advantage for Canadians.

Debt Management Objectives

The fundamental debt management objective is to provide stable, low-cost funding for the Government.

The fundamental objective of debt management is to provide stable, low-cost funding to meet the financial obligations and liquidity needs of the Government of Canada. A key strategic objective is to maintain a well-functioning market for Government of Canada securities. A well-functioning market contributes to keeping costs low.

Debt Management Principles

Public debt is managed according to a set of key principles.

The following operational principles guide the federal government's pursuit of these objectives:

- **Prudence:** Manage the composition of the debt to help protect the Government's fiscal position from unexpected increases in interest rates. Manage reserves within a framework that mitigates currency and interest rate risks. Manage the Receiver General cash position to ensure that adequate liquidity is maintained at reasonable cost to the Government.
- **Effectiveness:** Emphasize transparency, liquidity and regularity in the design and implementation of domestic debt programs in order to maintain a well-functioning domestic market.
- **Diversification:** Borrow using a variety of instruments and range of maturities to keep costs low and maintain a diversified investor base.
- **Market integrity:** Work with market participants and regulators to enhance the integrity and attractiveness to investors of Government of Canada securities.
- **Consultations:** Seek input from market participants on major adjustments to the federal debt and cash management programs.
- **Best practices:** Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

Debt Management General Strategy

The Government operationalizes these principles in the following manner:

Domestic Market

The Government borrows regularly in domestic markets.

- The Government structures the maturity profile of the debt in a way that balances lower financing costs with reasonable cost stability and refinancing risk under a wide range of potential future interest rate environments over the long term. The target debt structure is established using long-term analysis and is not based on a particular interest rate outlook (see “Balancing Prudence and Cost: Debt Structure” on page 19).
- To enhance the functionality of the market, the Government borrows on a regular, pre-announced basis in key segments of the market, builds large bond benchmarks and maintains a set of rules for participation at Government of Canada securities auctions.¹
- The Government maintains a diversified investor base by auctioning nominal bonds, real return bonds and Treasury bills in the wholesale market and by selling savings products to Canadians in the retail market.²

Foreign Currency

The Government borrows as required to maintain the foreign reserves portfolio.

- The Government of Canada funds its foreign exchange reserves through diverse sources and structures the maturity of the debt to limit refinancing risk.
- The Government of Canada’s foreign exchange reserves are composed of a range of diversified assets, determined by asset portfolio objectives and market conditions.
- Foreign liabilities are matched with reserve assets to immunize currency and interest rate risks.

¹ See the section “Domestic Distribution System” in Annex 1 of the 2001–02 *Debt Management Report*, available on the Department of Finance Web site at www.fin.gc.ca.

² See Annex 2 of the 2001–02 *Debt Management Report*.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government projects balanced budgets or better for 2002–03 and for each of the next two fiscal years.

The Government's fiscal policy sets the context for debt management operations. The federal government recorded budgetary surpluses over the previous five fiscal years and reduced the federal debt by \$47.6 billion. As announced in the February 2003 budget, the Government is committed to maintaining balanced budgets or better for 2002–03 and for each of the next two fiscal years.

Contingency Reserve and Debt Reduction

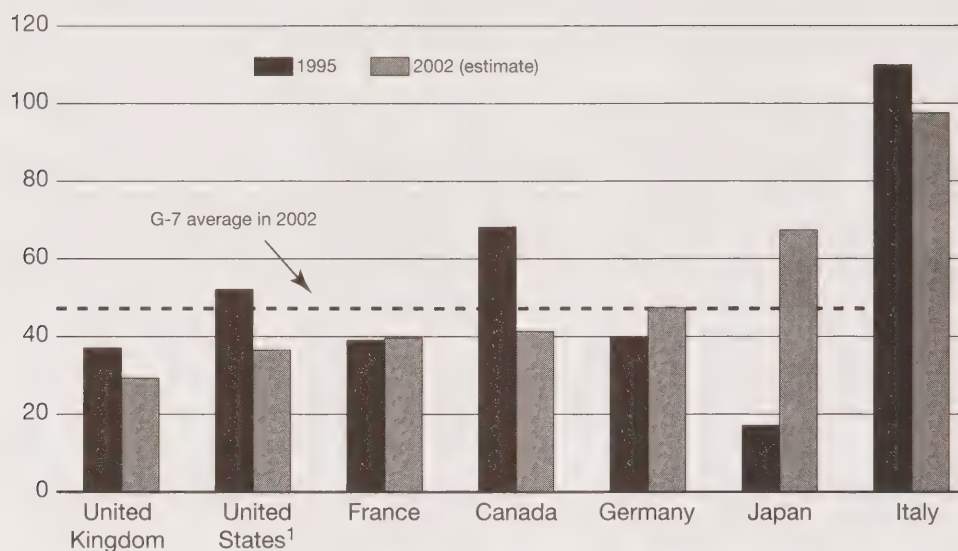
The Government of Canada sets aside an annual Contingency Reserve of \$3 billion to cover risks arising from unforeseen circumstances and variations in budget planning. The Contingency Reserve, if not needed, will be used to reduce federal debt.

The debt-to-GDP ratio is on a downward track.

Combined with forecast economic growth, the federal debt-to-GDP ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt (accumulated deficit) as a percentage of the economy is projected to fall to 44.5 per cent in 2002–03, down from its peak of 67.5 per cent in 1995–96. With the commitment to balanced budgets in each of the next two fiscal years, it is forecast to decline to about 40 per cent in 2004–05.

In terms of international debt burden comparisons, taking into account the accounting methods of various sovereigns, the debt burden of Canada's total government sector has declined the fastest among G-7 countries since the mid-1990s. Between 1995 and 2002, Canada's net financial liabilities as a percentage of GDP (akin to the debt-to-GDP ratio) declined by 26.8 percentage points. Consequently, Canada's total government debt burden moved below the G-7 average, and only the United Kingdom and the United States are expected to have lower debt burdens than Canada in 2003.

Total Government Net Financial Liabilities (per cent of GDP)



¹ Adjusted to exclude certain government employee pension liabilities, in order to be comparable with other countries' measures.

Source: OECD Economic Outlook, No. 72 (December 2002); Federal Reserve, *Flow of Funds Accounts of the United States* (December 2002); Department of Finance calculations.

Financial Balance (Excluding Foreign Exchange Transactions)

The key measure used for debt management planning is the Government's financial balance.

The key budgetary measure for debt management planning is the financial balance—requirement or source—rather than the budgetary balance (see box on page 15). The budgetary balance is presented on a full accrual basis, recognizing revenues and expenses when they are incurred. In contrast, the financial balance is on a cash basis, representing the actual cash flow sources and uses related to budgetary items.

Foreign Exchange Transactions

The movement in the value of foreign currencies compared to the Canadian dollar engenders revaluation gains or losses in the value of the foreign exchange reserves. Canada's commitment to the International Monetary Fund (IMF) also results in foreign denominated funds flowing between Canada and the IMF. These transactions may either raise or lower the size of the net financial balance.

***Measuring the Government's Fiscal Position:
Budgetary Balance and Financial Balance***

The budgetary balance and financial balance measures used in the *Debt Management Strategy* are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General, the Government is moving to full accrual accounting in 2002–03. This will enhance transparency and decision making by providing a more complete accounting of government activities than under the previous modified accrual accounting framework. Under a full accrual basis of accounting, revenues and expenses are recorded when they are incurred, regardless of when the actual cash flows occur. For more information see Annex 6 of the February 2003 *Budget Plan*, available on the Department of Finance Web site at www.fin.gc.ca.

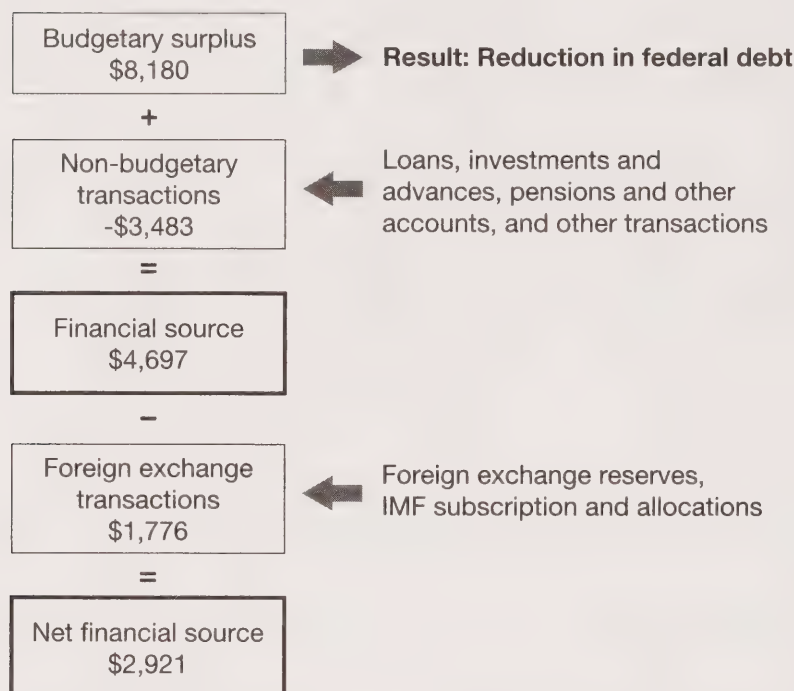
The financial balance—requirement or source—provides a measure of the net cash position of the Government. In contrast, the budgetary balance also includes obligations incurred by the Government during the course of the year for which the cash transaction does not take place until future years. The financial requirement/source only includes the cash outlay related to these obligations.

The net financial balance includes foreign exchange transactions, which represent all transactions in international reserves held in the Exchange Fund Account and commitments to the IMF. The net financial balance corresponds closely to the unified budget balance measure used in the United States.

The chart below provides an illustration of the various elements of the Government's budgetary framework, based on the 2001–02 fiscal year:

Transactions for the Year Ending March 31, 2002

(in millions of dollars)



Source: *The Budget Plan* (2003), Department of Finance.

Net Financial Balance Outlook

For 2002–03, the Government expects a domestic financial balance of \$3.4 billion.

The Government expects a financial requirement in 2003–04.

For 2002–03, the Government expects to achieve a domestic financial balance of \$3.4 billion. A net financial source, which takes into account foreign exchange transactions, is also expected, mainly due to the revaluation effects in the Exchange Fund Account.

The Government expects modest financial requirements in 2003–04. These include the funding of the Canada Student Loans Program and the proposed transfer of Canada Pension Plan (CPP) operating balances, currently held by the Government, to the CPP Investment Board, as proposed in legislation currently before Parliament. The CPP funds transfer would involve switching non-market debt to market debt, which would engender a cash requirement but would not have any effect on the level of federal debt.

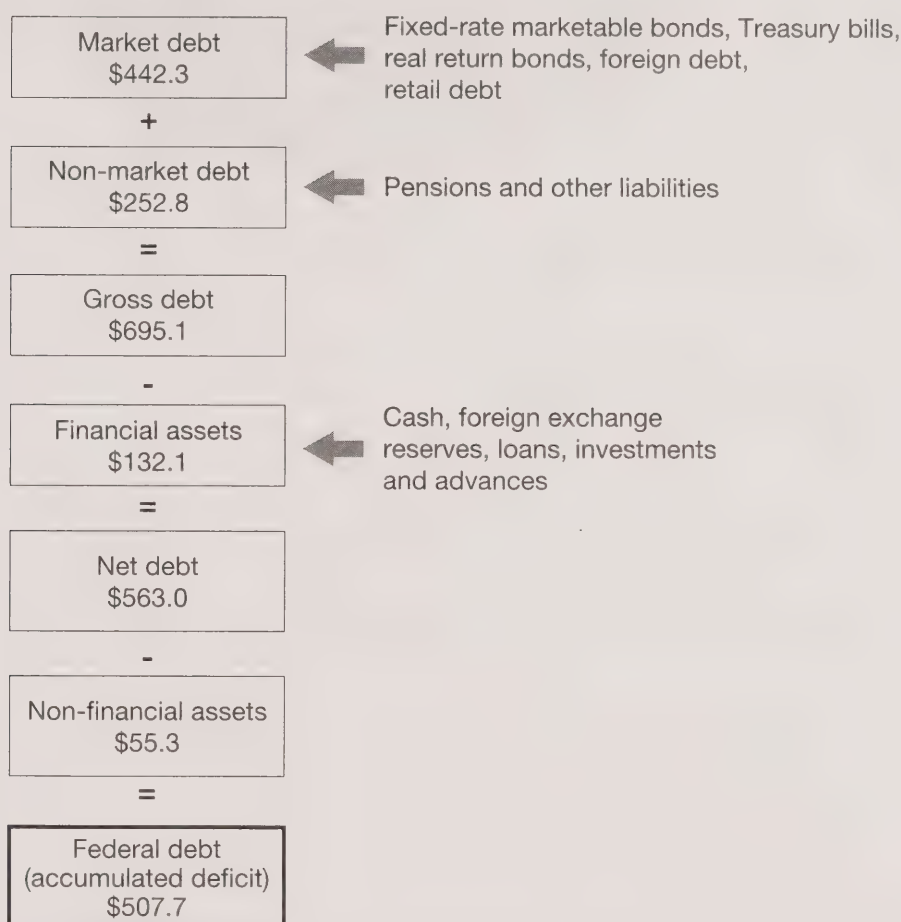
The market debt component of federal government liabilities is the focus of debt strategy.

Debt Composition

Debt management operations focus on market debt, which is only one component of the total federal government liabilities and financial assets. The other component of the gross debt, non-market debt, is taken into account in debt strategy planning, but is not subject to debt management strategy initiatives. Non-market debt includes federal public sector pension liabilities and the Government's accrued liabilities. The chart below illustrates the relationships between the components of the federal debt, based on the 2001–02 fiscal year.

Total Federal Debt as of March 31, 2002

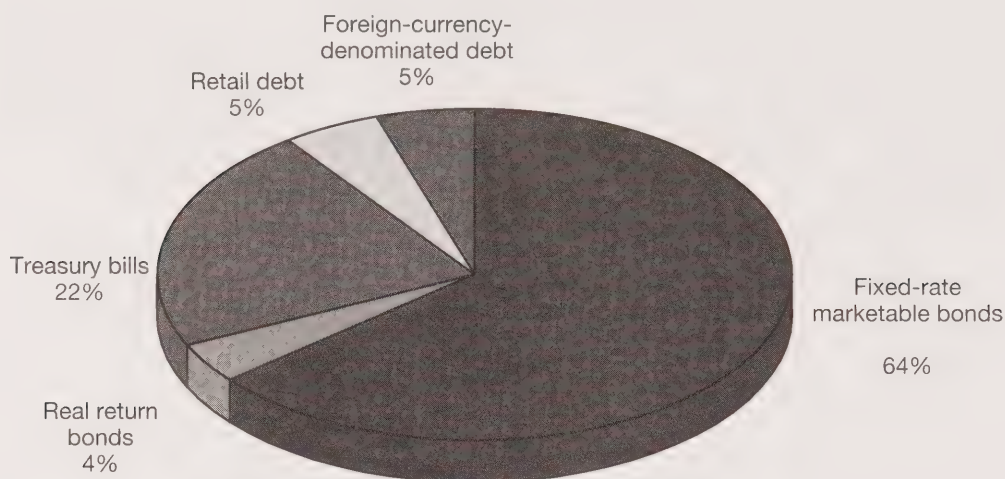
(in billions of dollars)



Source: *The Budget Plan* (2003), Department of Finance.

The federal government's market debt consists of fixed-rate marketable bonds, real return bonds, Treasury bills, retail debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt. Financial assets held by the Government include operating cash balances, loans and investments, and foreign exchange reserves. Non-financial assets include land, buildings and infrastructure, and vehicles.

Forecast Composition of Market Debt March 31, 2003



Note: Excludes bonds issued to the Canada Pension Plan.
Source: Department of Finance.

Market Debt Outlook

Some modest market debt retirement is expected in 2002–03.

The federal debt declined by \$8.2 billion in 2001–02 and by \$47.6 billion over the past five fiscal years. Market debt, the portion of the federal debt that is funded in capital markets, declined by \$4.1 billion in 2001–02 and by \$34.6 billion over the past five fiscal years. A further decline is expected in 2002–03.

In 2003–04, the Government expects to fund its cash requirements within the existing level of borrowing authority (see box below).

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained to raise new market debt, in the form of a borrowing authority bill. Once obtained, the authority to raise debt levels generally extends through the remainder of the fiscal year and lapses at the start of the next fiscal year.

Currently available new borrowing authority is limited to a \$4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act.

2003–2004 Debt Management Strategy

Balancing Prudence and Cost: Debt Structure

The Government maintains a prudent debt structure.

One of the Government's key objectives in managing the debt is to strike the appropriate balance between low financing costs and cost stability. In general, borrowing long-term debt is less risky, but more costly, than borrowing short-term debt. The Government maintains a prudent debt structure to protect its fiscal position from unexpected increases in interest rates and to limit annual refinancing needs. One of the measures of prudence is the fixed-rate share of debt—that is, the share of the debt that does not need to be refinanced within a year.

During the 1990s, the Government raised the fixed-rate share of the federal debt from one-half to two-thirds to provide more cost stability in an environment of fiscal and current account deficits, volatile interest rates and high debt levels.

Over the past five years, Canada's fiscal and economic position has strengthened.

Over the past five years, our economic and fiscal position has strengthened. Canada now has low and stable inflation and interest rates, strong employment growth, lower foreign indebtedness and a current account surplus. The federal debt level has fallen by over \$47 billion and is at its lowest level, relative to the size of the economy, in nearly two decades. The reduction in the debt level has provided Canada with greater financial stability, reduced vulnerability to events happening beyond our borders, and contributed to the restoration of Canada's triple-A credit rating.

As a result of these positive economic and fiscal developments, the Government is now in a position to reduce the fixed-rate portion of the debt. While this reduction is being taken to lower future financing costs, the debt structure remains prudent, with a majority of the debt being fixed-rate.

The target for the fixed-rate portion of the debt will be reduced from two-thirds to 60 per cent.

As announced in the February 2003 budget, the Government now intends to reduce the target for the fixed-rate portion of the debt from two-thirds to 60 per cent. The reduction will begin in the upcoming fiscal year and will be implemented in an orderly and transparent manner over the next five years to allow the market time to adjust to the required changes in debt stocks.

Based on the budget outlook, the planned change to the debt structure is expected to reduce the Government's net debt-servicing costs by up to \$750 million during the five-year transition period and by up to \$500 million, on average, each year thereafter. These savings can be used to meet the priorities of Canadians.

The decision to lower the fixed-rate target is not based on a particular interest rate outlook. Analytical work using stochastic simulation (see the Annex) was used to assess the balance between the costs and risks of alternative debt structures. The analysis uses dynamics of historical interest rates observed over the period 1994–2002 and assumes that this interest rate environment continues to prevail over the coming years.

A prudent debt structure will still be maintained, with the majority of the debt being fixed-rate.

Compared to the current two-thirds debt structure, the lower fixed-rate structure would modestly raise the Government's short-term exposure to adverse movements in interest rates. For example, a 100-basis-point increase in interest rates along the entire yield curve would raise federal net debt-servicing costs³ by \$1.1 billion in the first year with a 60-per-cent fixed-rate structure, compared to \$800 million for a two-thirds debt structure. By comparison, the impact of the same interest rate shock was estimated at \$1.8 billion in the mid-1990s.

The change in the debt structure is expected to lower debt costs.

However, the analysis indicates that it is highly unlikely that the additional debt costs stemming from a severe interest rate shock would be disruptive to the budgetary framework. Over time, the additional costs of an interest rate shock would be more than offset by the savings associated with a lower fixed-rate structure.

The target 60-per-cent debt structure would also continue to prudently limit the need to refinance a large portion of the debt in any given period.

Maintaining a Well-Functioning Market

Maintaining a well-functioning market for Government of Canada securities is important.

As the sovereign and major borrower in the fixed-income marketplace, the Government needs to sustain a liquid and efficient market for Government of Canada securities for the purpose of providing stable low-cost funding for the Government. Moreover, this provides key pricing and hedging tools for market participants and thereby contributes to the health of the broader fixed-income market.

A number of operational initiatives will be taken to enhance the effectiveness of auctions and buyback operations.

In 2003–04, a number of operational initiatives will be taken to enhance the effectiveness of Government of Canada auctions and buyback operations, specifically for the purposes of increasing liquidity and participation and reducing risks borne by market participants (see next section for full details).

In developing its debt program plans, the Government conducts extensive consultations with market participants. Reports on topics of discussion and views received from market participants are posted on the Bank of Canada's Web site at www.bankofcanada.ca. A summary of comments received during recent consultations has been published concurrently with the release of this document. As in past years, the Government plans to consult further with market participants on potential adjustments to debt program plans during the 2003–04 fiscal year.

The full range of initiatives being undertaken to maintain and enhance operational effectiveness in the areas of domestic debt, cash and reserves management is summarized in the following table and detailed in the following sections of the publication.

³ That is, the increase in debt-servicing costs net of the increased earnings on interest-bearing assets.

2003–2004 Debt Strategy Plan

2003–2004 Debt Strategy Action Plan and Intended Results

Debt Structure

Objective: *Gradually reduce the fixed-rate share of debt.*

Action for 2003–04:

- Reduce the fixed-rate share of debt from 67 per cent towards a medium-term target of 60 per cent.
- Increase the size of the Treasury bill program from about \$105 billion in 2002–03 to approximately \$120 billion in 2003–04.
- Issue about \$40 billion of bonds in 2003–04, similar to the amount in 2002–03. Due to large bond maturities and continued cash management bond buyback operations, the bond stock is expected to decrease by some \$10 billion.
- Continue a similar level of bond buybacks as in 2002–03 of about \$13 billion.
- Maintain a stable maturity profile.

Intended Result:

- ➔ Achieve lower debt charges, while continuing to prudently mitigate the risk to the budget framework.
- ➔ Facilitate market adjustment to changes in the bond and Treasury bill stock.
- ➔ Limit the need to refinance a large portion of debt in any given period.

Domestic Debt Programs

Objective: *Maintain diversified sources of funding and a well-functioning market.*

Action for 2003–04:

- Continue regular issues of marketable bonds in four maturity sectors, Treasury bills in three maturity sectors and index-linked bonds in wholesale markets, as well as a retail debt program.
- Continue to borrow on a pre-announced basis, seek input from market participants on major adjustments to programs, and provide timely notices of government policy decisions.
- Maintain current benchmark target sizes for 2-, 5- and 30-year bonds.
- Reduce 10-year benchmark size from \$12 billion–\$15 billion to \$10 billion–\$14 billion to maintain an annual benchmark.
- Modestly increase the amount of buybacks on a switch basis and slightly lower the amount of bonds repurchased on a cash basis.
- Implement the cash management bond buyback (CMBB) program on a regular basis.
- Reduce the 2-year auction size to a minimum of \$2.5 billion when the benchmark is fungible with a large outstanding bond.
- Move Treasury bill auctions from 12:30 p.m. to 10:30 a.m. on a trial basis. Schedule CMBB after Treasury bill auctions.
- Consider further reductions in operational turnaround times.

Intended Result:

- ➔ Keep costs low and mitigate funding risk by diversifying borrowing across investor segments, instruments and maturities.
- ➔ Maintain transparency and efficiency.
- ➔ Maintain a liquid market for on-the-run issues and building-benchmark issues.
- ➔ Support liquidity in the swap and futures market and enhance international demand.
- ➔ Support new bond issuance and maintain the time required to build benchmarks.
- ➔ Smooth cash requirements by reducing peak cash balances needed to redeem upcoming large maturities.
- ➔ Enhance the bidding process and participation.
- ➔ Reduce market participants' risk.

Cash Management

Objective: *Invest government balances prudently while obtaining an appropriate rate of return.*

Action for 2003–04:

- Broaden the list of participants in collateralized cash management operations.

Intended Result:

- ➔ Reduce exposure to counterparty credit risk and encourage more competitive bidding at cash management auctions.

Foreign Reserves and Debt Programs

Objective: *Improve the cost-effectiveness of funding foreign reserve assets.*

Action for 2003–04:

- Continue to use cross-currency swaps.

Intended Result:

- ➔ Reduce the cost of carrying reserve assets.

Domestic Debt Programs

The adjustments to debt programs required in 2003–04 will be relatively modest. The gross bond and buyback programs will remain at similar levels to those of 2002–03, with the stock of bonds decreasing from \$265 billion to \$255 billion due to maturities and cash management bond buyback operations during the year. The Treasury bill program will increase by about \$15 billion in 2003–04.

Fixed-Rate Marketable Bond Program

Bond program activity and issuance frequency will be maintained.

In 2003–04 some \$35 billion of bonds will be maturing. Gross bond program issuance in 2003–04 is planned to be about \$40 billion.

In 2003–04, the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds, and semi-annual 30-year bond auctions. As in previous years, a transparent quarterly calendar of auctions will be posted on the Bank of Canada Web site shortly before the start of each quarter.

The 2-, 5- and 30-year benchmark target sizes will remain unchanged.

The 2-, 5- and 30-year benchmark target sizes will remain unchanged from last year (2-year bonds: \$7 billion to \$10 billion, 5-year bonds: \$9 billion to \$12 billion, and 30-year bonds: \$12 billion to \$15 billion). The benchmark sizes will be achieved through reopenings where a particular bond issue is sold at several auctions until the benchmark target range is reached.

The 10-year benchmark size will be reduced to \$10–\$14 billion.

The 10-year benchmark target range will be reduced from \$12 billion–\$15 billion to \$10 billion–\$14 billion to maintain an annual cycle for the benchmark-building process. This initiative will ensure the availability of a current, liquid 10-year security and support a liquid futures market by maintaining a viable basket of eligible government securities. Debt strategy consultations conducted in December 2002 indicated that market participants strongly favour the issuance of one 10-year benchmark per year to encourage international demand as well as liquidity in the swap and futures market in Canada.

To address cash management challenges associated with a large amount of bonds maturing on the same date, the 2-year auction size may be, on occasion, as little as \$2.5 billion when the building benchmark is interchangeable with a large outstanding bond.

Bond Buyback Program

There are two types of bond buyback programs—regular bond buybacks and cash management bond buybacks. Regular bond buybacks permit the maintenance of a liquid new bond issue program by buying back older, less liquid bonds with a remaining term to maturity from 1 to 25 years. The buyback program is sizeable and plays a strategic role in maintaining an active new issue bond program. The second kind of buyback program, called cash management bond buyback, aids in the management of the Government's cash balances by buying back bonds maturing within the next 18 months.

Regular Bond Buyback Operations

Regular bond buyback operations can be conducted on a cash basis or a switch basis.

Bond buyback operations can be conducted on a cash or switch basis. Bond buyback operations on a cash basis involve the exchange of less liquid bonds for cash and are conducted shortly after auctions of similar maturity bonds. Bond buyback operations on a switch basis involve the exchange of less liquid bonds for new issue bonds on a duration-neutral basis and are conducted at other times in each quarter.

The Government intends to conduct roughly the same level of bond buyback operations in 2003–04.

The Government plans to conduct about \$13 billion in bond buyback operations in 2003–04, similar to 2002–03. The amount of buybacks on a switch basis will be increased by approximately \$1 billion to approximately \$6 billion, while buybacks on a cash basis will be reduced by about \$200 million to \$7 billion. The target size of the bond buyback programs and the timing of operations will be announced through the quarterly bond auction calendar published by the Bank of Canada at www.bankofcanada.ca.

Buybacks on a switch basis will be continued and increased.

To broaden participation in buyback operations, buybacks on a switch basis were introduced on a pilot basis in December 2001. Market participants have received the program very well and the size objectives of the program have been achieved. The pilot program will be continued and increased in size in 2003–04, as operational parameters are assessed and potentially adjusted to improve the program's effectiveness.

The framework for net position reporting will apply to switch buybacks.

To ensure market integrity, a framework for the reporting of net positions, similar to the one applying to auctions, will be implemented for buybacks on a switch basis in 2003–04.

Illiquid bonds may be removed from the basket of eligible bonds for buyback operations on a cash basis.

To ensure efficient operations, illiquid bonds may be removed from buyback operations on a cash basis. These illiquid bonds will continue to be included in the basket for buyback operations on a switch basis.

A list of outstanding Government of Canada bonds, including their maturity dates, is contained in the 2001-02 *Debt Management Report*, which is available on the Department of Finance Web site at www.fin.gc.ca. The list will also be available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be posted on the Bank of Canada's Web site.

Cash Management Bond Buybacks

The cash management bond buyback program will be made permanent in 2003–04.

To help in smoothing the Government's cash requirements, a pilot program of cash management bond buybacks (CMBB) was implemented in 2000–01. The pilot program was continued in 2002–03 as operational parameters and effectiveness were assessed and adjusted. During debt strategy consultations, market participants expressed strong support for the program. From the Government's perspective, the program is successfully meeting its objectives. Therefore the CMBB program will be made permanent in 2003–04.

Real Return Bonds (RRBs)

In 2003–04, the Government plans to issue approximately \$1.5 billion of RRBs.

Similar to 2002–03, the Government plans to issue approximately \$1.5 billion of RRBs in 2003–04 through quarterly price auctions.

The Government will be reviewing the RRB program in light of the evolution of the macroeconomic environment, the new debt structure target and the objectives of the program. The review will include consultations with market participants.

Treasury Bill Program

Based on the budget outlook and plans for attaining the new 60-per-cent target for the fixed-rate portion of the debt, the stock of Treasury bills is expected to be about \$120 billion by the end of 2003–04.

The Treasury bill auction time will be moved on a trial basis from 12:30 p.m. to 10:30 a.m.

Recent consultations have indicated that market participants favour moving Treasury bill auctions to before noon, when market liquidity and participation are at a peak. Starting April 22, 2003, the Treasury bill auction time will be moved on a trial basis from 12:30 p.m. to 10:30 a.m. and CMBB operations will be conducted shortly after Treasury bill auctions.

Domestic Market Development

The Department of Finance and the Bank of Canada have an ongoing dialogue with market participants and regulators on the development of the fixed-income market in Canada. Ongoing discussions are focused on the development and regulation of electronic trading systems. Electronic trading systems, which are just appearing in Canada, have the potential to significantly improve the transparency and efficiency of the fixed-income market.

Retail Debt Program

In 2003–04, the Government will continue to focus on keeping the non-marketable retail debt portfolio and costs aligned with a declining debt environment while investing in innovation to maintain a vibrant and creative Retail Debt Program.

Targeted initiatives will continue to focus on increasing access and diversifying the investor base through the deployment of new cost-effective electronic processing and new products and services, and by evolving the brand through integrated and cost-effective marketing. Details on specific initiatives will be announced at the appropriate time.

Management of the Government's Cash Balances

The Government manages its cash balances in order to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. The cash balances are invested through twice daily auctions.

A new framework brings the management of cash balances in line with best practices of other sovereigns.

In September 2002, the Government implemented a new framework to bring the Government's operations in line with the best practices of other governments and market participants.

The two key modifications to the framework are the introduction of a credit management system, using credit ratings, credit lines and collateral (through sale and repurchase agreements) to better manage credit risk, and a broadening of the list of eligible counterparties to encourage more competitive bidding at the auctions.

The new framework applies to the morning auction, where the bulk of the cash balances are auctioned. The afternoon auction will continue to be used to invest the Government's residual cash balances and will remain uncollateralized and limited to Large Value Transfer System participants—unchanged from the previous framework.

No further modifications to the framework are planned for 2003–04.

The new system is working well and overall uncollateralized exposure, as well as exposure to individual institutions, has been reduced considerably. No further modifications to the framework are planned for 2003–04 and the Government will continue its efforts to bring new participants into the framework.

Foreign Reserves Debt Programs

The Government holds foreign exchange reserve assets in the Exchange Fund Account to provide the Government with foreign currency liquidity and to provide the funds needed to help promote orderly conditions for the Canadian dollar in foreign exchange markets. Further details on the management of international reserves are available in the *Exchange Fund Account Annual Report*, available on the Department of Finance Web site at www.fin.gc.ca.

The Government's foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis.

The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis, based on many of the same principles used by other sovereigns and private sector financial institutions, including prudent risk management principles.

The key objectives of reserves management are:

- Ensure that an appropriate level of reserves is maintained while minimizing the cost of carrying reserves (i.e. the difference between interest paid on foreign currency liabilities and the interest earned on reserve assets).
- Immunize interest rate and currency risks by selecting reserve assets that match the duration and currency of liabilities.
- Maintain diversified funding sources and a prudent liability structure to help manage refinancing needs.

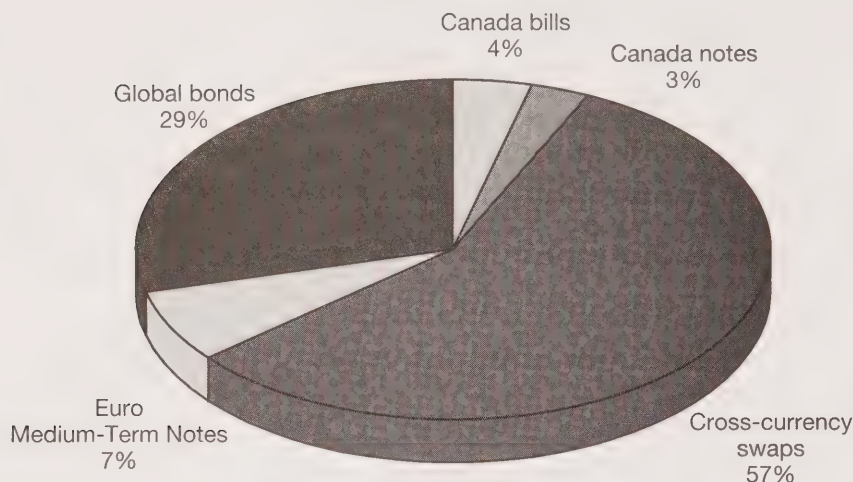
Funding Sources

The Government has been using cross-currency swaps to obtain highly cost-efficient funding.

The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar discount note program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps have proven to be a particularly cost-effective alternative, and have been actively used in recent years.

Cross-currency swaps will continue to be the primary source of reserve funding.

In 2003–04, the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations will continue to be the primary source of reserve funding.

**Forecast Composition of Foreign Currency Liabilities
March 31, 2003**

Source: Department of Finance.

Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. The Government's risk management policies call for prudent management of treasury risks based on best practices of sovereign treasury operations and private sector financial institutions. Standards for risk tolerance are very prudent, with market risks immunized and high credit quality and diversification standards followed.

Annex—Analytical Framework: Balancing Cost and Risk

By maintaining a prudent debt structure, the Government seeks to keep borrowing costs low while ensuring that the cost impact of unexpected increases in interest rates does not disrupt the budgetary framework.

In determining the composition and maturity profile of the debt, the Government takes a long-term perspective with respect to the trade-off between the cost and risk of issuing various forms of debt. The trade-off reflects the fact that, from a borrower's point of view, longer-term debt instruments are generally more costly and less risky than shorter-term debt instruments.

The trade-off between cost and risk occurs because long-term instruments such as Government of Canada bonds generally pay higher interest rates than short-term instruments such as Treasury bills. On the other hand, coupon payments of long-term bonds remain at a constant level until the bond matures, resulting in lower interest rate risk compared to short-term instruments, which need to be refinanced more often at prevailing market rates. The higher the proportion of short-term instruments, the higher the risk that an unfavourable interest rate movement could have a negative impact on annual debt costs.

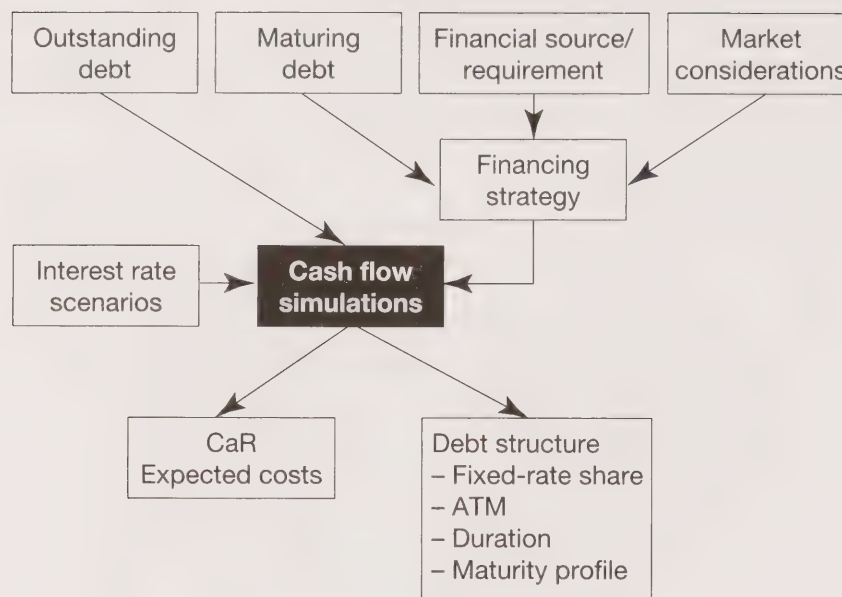
As part of debt strategy planning, the fixed-rate debt structure is continually being reviewed to assess its suitability given changes in the fiscal and economic environment.

To assess the ability of the debt structure to limit the exposure to interest rate fluctuations, the Department of Finance and the Bank of Canada use simulation models to evaluate potential debt costs under a large number of interest rate scenarios. Among other measures, consideration is also given to the average term to maturity (ATM), duration and maturity profile of the debt.

Cost at Risk (CaR) is one of the key measures the Government uses to identify whether the risk of higher debt costs falls within the Government's tolerance for risk. CaR represents the difference between the maximum level of debt costs that could be anticipated with a high degree of certainty and the expected level of debt costs over a given time horizon.

The simulation framework that is used to model the cost and risk characteristics of alternative debt structures is depicted below. An important input into the model is the interest rate scenarios. For the analysis, 10,000 scenarios have been developed, based on a theoretical model from the economic literature and the dynamics of interest rates observed over the 1994–2002 period. These scenarios represent the full range of plausible developments in interest rates going forward. The analysis therefore assumes that the recent interest rate environment, characterized by relatively stable inflation and lower interest rate volatility, continues to prevail over the coming years.

Simulation Framework



Several financing strategies are developed, taking into account the fiscal outlook, amount of maturing debt and market considerations. The simulation is then performed for all interest rate scenarios to generate a statistical distribution of possible debt costs and various statistics for each financing strategy.

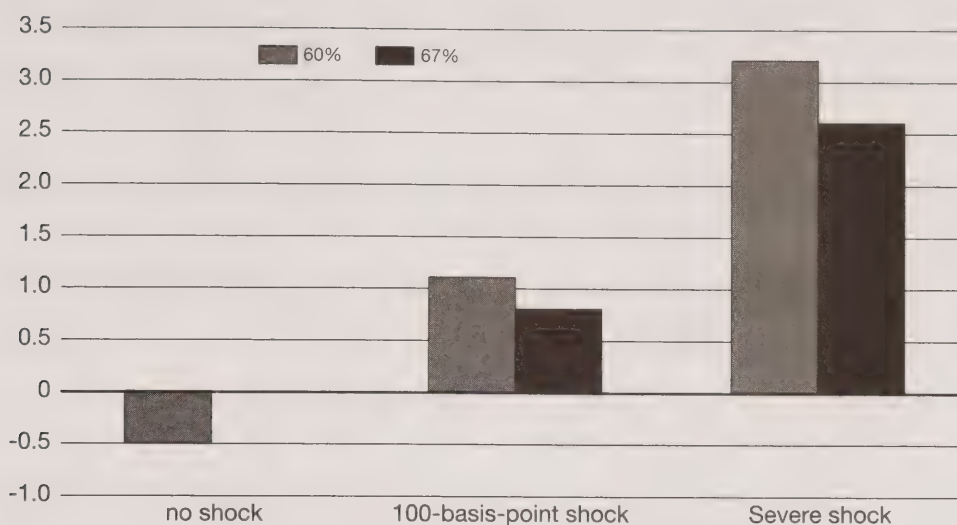
The CaR analysis conducted in 2002–03 indicates that, when viewed over a long-term horizon, the costs and risks of alternative debt structures within the range of 60 per cent to 67 per cent are fairly similar. Debt structures in this range would accommodate the impact of most interest rate shocks without unduly affecting the Government's fiscal framework.

The CaR results indicate that a fixed-rate share target of 60 per cent would result in lower debt-servicing costs compared to the two-thirds target while still maintaining a prudent debt structure. Over time, the expected debt cost savings with a lower fixed-rate structure would offset the potential volatility in debt costs due to interest rate risk and offer some prospect for overall lower debt costs.

Stress Testing

Research on simulation modelling has shown that results are often highly sensitive to the assumptions employed. The characteristics of the interest rate scenarios used in the CaR model are critical and, inevitably, subjective. Moreover, simulations may not adequately capture the impact of extreme interest rate shocks.

Debt Cost Sensitivity to Interest Rate Shocks (in billions of dollars)



Source: Department of Finance.

The examination of severe interest rate scenarios remains an important factor considered in prudent debt management decisions. The above figure provides an illustration of the potential increase in costs after one year for a 60-per-cent and a two-thirds fixed-rate debt structure resulting from two interest rate shocks.

The 60-per-cent fixed-rate debt structure would be more exposed to a more severe interest rate shock than a two-thirds debt structure. The shock above, designed to resemble the increase in interest rates that occurred in 1994, would cause federal net debt-servicing costs to increase by about \$3.2 billion in the first year for a 60-per-cent fixed-rate structure, compared to \$2.6 billion for a two-thirds fixed-rate share. Over a medium-term period, however, the benefits of the two-thirds structure are offset by higher debt-servicing charges.

Average Term to Maturity

The average term to maturity of the debt will stabilize.

Average term to maturity (ATM), measured in years, represents the average length of time before debt instruments mature and are subject to refinancing risk. The ATM of marketable debt has increased from roughly 4 years in 1990 to 6½ years in March 2002, which is at the upper end of the range of comparable sovereigns. The upward trend in ATM resulted from the increase in the fixed-rate share, the reduction in the stock of Treasury bills, and the continued issuance of 30-year bonds. The decision to lower the fixed-rate share of the debt over the coming years will have the effect of stabilizing the ATM.

Glossary

average term to maturity (ATM): The average time remaining before debt matures, taking only principal amounts into account.

basis point: One basis point is equal to 0.0001, or 0.01%.

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenditures. A deficit is the shortfall between government revenues and budgetary expenditures.

buyback on a cash basis: The repurchase of bonds for cash. Used to maintain the size of a new issuance.

buyback on a switch basis: The exchange of outstanding bonds for new bonds in the benchmark being built. Used to maintain the size of a new issuance.

Canada bill: Promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Notes can be issued for terms of nine months or longer and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserve funding purposes only.

Canada Premium Bond (CPB): CPBs are a savings product for individual Canadians introduced by the Government of Canada in 1998. They are offered for sale by most Canadian financial institutions, offer a higher interest rate compared to CSBs, and are redeemable without penalty once a year on the anniversary of the issue date or during the 30 days thereafter.

Canada Savings Bond (CSB): CSBs are currently offered for sale by most Canadian financial institutions to individual Canadians. CSBs pay a competitive rate of interest that is guaranteed for one or more years. They may be cashed at any time and, after the first three months, pay interest up to the end of the month prior to encashment.

Contingency Reserve: Is included in the budget projections primarily to cover risks arising from unpredictable events or unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts. If not needed, it is used to reduce the federal debt.

Cost at risk: A dollar risk measure that represents the potential excess debt charges over a one-year horizon that the debt manager is X% certain not to exceed.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

electronic trading system: An electronic system that provides real-time information about securities and enables the user to execute financial trades.

Exchange Fund Account: The principal repository of Canada's official foreign reserves, used to provide foreign currency liquidity and promote orderly conditions for the Canadian dollar in the foreign exchange market.

federal debt: accumulated deficit, i.e., the sum of all surpluses and deficits in the past.

financial balance: Measures the difference between the cash coming in to the Government and the cash going out. In the case of a financial requirement, it is therefore the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fixed-rate marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fungible bond: A bond that has the same financial attributes as another; the bonds are interchangeable.

government securities distributor (GSD): GSDs are members of a group of investment banks and dealers through which the Government distributes Government of Canada Treasury bills and marketable bonds.

gross public debt: Total amount the Government owes. It consists of both market debt and internal debt owed mainly to the superannuation accounts for government employees and other current liabilities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

marketable debt: A marketable debt instrument is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets, and includes marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds), foreign-currency-denominated bonds and bills, as well as bonds issued to the Canada Pension Plan.

market transparency: Within the context of debt management, characterization of a bond market where debt management strategies and operations are known and well understood by market participants.

net debt: Federal gross public debt, net of financial assets.

non-marketable debt: Interest-bearing debt that is not traded in secondary markets.

non-market debt: Includes the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest and payment of matured debt).

primary market: Market for new issues of securities.

real return bond (RRB): Government of Canada real return bonds pay semi-annual interest based upon a real interest rate. Unlike standard fixed-rate marketable bonds, interest payments on RRBs are adjusted for changes in the consumer price index.

secondary market: Market where securities are bought and sold after issuance.

sovereign market: Market for the debt issued by a government.

Treasury bill: Short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6 or 12 months are currently auctioned on a biweekly basis.

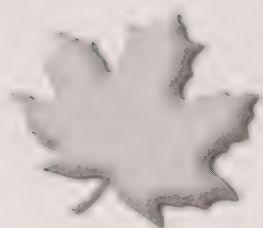
turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

yield curve: Graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.



DEBT MANAGEMENT STRATEGY

2004–2005



DEBT MANAGEMENT STRATEGY

2004–2005



Department of Finance
Canada

Ministère des Finances
Canada



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Foreword by the Minister of Finance

I am pleased to table before Parliament the Government of Canada's *Debt Management Strategy* for fiscal year 2004–05. This document provides comprehensive information on the Government's debt strategy and objectives for the coming fiscal year.

Canada's commitment to prudent financial management has been the foundation of Canada's recent economic and policy success, and enabled us to weather a number of unexpected shocks in 2003. The Government recently presented its seventh consecutive balanced budget, and Canada is the only Group of Seven (G-7) country expected to post a balanced budget in 2004. According to the Organisation for Economic Co-operation and Development (OECD), Canada's debt burden is also expected to be the lowest in the G-7 in 2004.

The benefits of this disciplined approach are many. Ongoing federal surpluses have enabled us to reduce our federal debt by more than \$52 billion since the budget was balanced in 1997–98. As a result, the federal debt-to-GDP (gross domestic product) ratio fell from 68 per cent in 1995–96 to 44 per cent in 2002–03. This reduction in the federal debt burden has led to lower interest charges of \$3 billion each year, savings that can be invested in the priorities of Canadians.

In spite of such hard-earned progress, however, interest charges remain our largest single budget expense, accounting for 21 cents of every revenue dollar received by the Government in 2002–03. Given the looming challenge of an aging population, our debt reduction efforts must continue. For this reason, Budget 2004 sets an objective of reducing the federal debt-to-GDP ratio to 25 per cent within 10 years.

It is only through sound fiscal management that Canada can foster a higher standard of living and a better quality of life today and for generations to come. This government remains determined to take the necessary steps to ensure long-term prosperity for all Canadians.

The Honourable Ralph Goodale, P.C., M.P.
Minister of Finance
Ottawa, March 30, 2004

Purpose of this Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance Canada that provides information on the Government of Canada's objectives and strategies for managing the outstanding stock of market debt and financial assets within the context of the fiscal environment.

The Government publishes a companion document, the *Debt Management Report*, which reports on the Government's debt operations over the previous fiscal year and provides detailed information on outstanding debt. This publication is available shortly after the release of the Public Accounts each year.

Focus of the Federal Debt Strategy

The debt strategy focuses on the management of the marketable debt and liquid financial assets of the Government of Canada.

As of March 31, 2003, the Government had \$439.8 billion of market debt composed of bonds, Treasury bills, retail debt, foreign currency debt, and Canada Pension Plan bonds, and \$65.5 billion of liquid financial assets composed of domestic cash balances and foreign exchange assets.

	(C\$ billions)
Market Debt	
<i>Payable in Canadian currency</i>	
Marketable bonds	288.2
(fixed-rate bonds with 2-, 5-, 10- and 30-year maturities and real return bonds with 30-year maturities)	
Treasury bills	104.4
(zero-coupon securities with 3-, 6- and 12-month maturities)	
Retail debt	22.6
(Canada Savings Bonds and Canada Premium Bonds)	
Canada Pension Plan bonds	3.4
<i>Payable in foreign currency</i>	
Marketable bonds	14.0
(fixed-rate bonds issued in US dollars and in other currencies)	
Canada bills	2.6
(zero-coupon securities with 1- to 9-month maturities)	
Foreign currency notes	4.5
(Canada notes and Euro Medium-Term Notes)	
Liquid Financial Assets	
Cash	16.5
Foreign exchange reserves	49.0

Highlights of the 2004–2005 Debt Strategy

- The Government will continue to target a gradual reduction in the fixed-rate share of the debt from two-thirds in 2002–03 to 60 per cent in 2007–08 to achieve savings on public debt charges while retaining a prudent debt structure.
- In moving to the new debt structure, the maintenance of a well-functioning market in Government of Canada securities is an important objective of the debt strategy.
- Thus, the change in the debt structure will continue to be made gradually through increases in the Treasury bill program and reductions in the bond program:
 - The size of the Treasury bill program will increase from \$110 billion–\$115 billion at the end of 2003–04 to approximately \$130 billion by the end of 2004–05.
 - The total amount of marketable bonds issued in 2004–05 will be about \$36 billion, moderately lower than in 2003–04. Net bond issuance of about \$25 billion will also be moderately lower than in 2003–04.
 - The planned amount of bond buybacks is in the order of \$11 billion, similar to 2003–04.
 - The bond stock will decrease from \$257 billion to about \$241 billion due to maturities and continued cash management buyback operations.
- The Government reviewed the real return bond program and the pilot switch buyback program in 2003–04 and is announcing that:
 - Real return bonds will remain a part of the Government’s debt program, with issuance in 2004–05 equal to or marginally higher than in previous years.
 - The switch buyback program will be maintained as an ongoing debt management tool.
- To enhance bidding and participation in domestic debt operations:
 - Beginning April 1, 2004, as supported by market participants, results for auctions and buybacks will be released in advance of the current fixed turnaround times on a “best efforts basis” (i.e. when ready). Turnaround times for auctions and buybacks are expected to decline to about 5 and 10 minutes respectively. Release times will vary from operation to operation, subject to a maximum turnaround time for auctions and buybacks of 10 and 15 minutes respectively. The Government will continue to take steps in the fiscal year to streamline these operations to further reduce turnaround times.
 - Morning operation times for both Treasury bill auctions and cash management buybacks introduced in June 2003 will be maintained.

Funds Management Framework

Government of Canada funds management encompasses a wide range of activities related to the issuance of debt and the management of liquid financial assets by the Government. Prudent and effective funds management is a key element of achieving the Government's objective of fiscal sustainability. Due to the nature and breadth of funds management activities, separate objectives have been established for domestic debt and cash management, and foreign reserves.

Domestic Debt and Cash Management Objectives

The fundamental objective of domestic debt and cash management is to provide stable, low-cost funding to meet the financial obligations and liquidity needs of the Government of Canada. Key strategic objectives are to maintain a prudent debt structure, maintain and enhance a well-functioning market for Government of Canada securities, and maintain a diversified investor base.

Domestic Debt and Cash Management Principles

In pursuit of these objectives, the Government of Canada manages its activities according to a set of key principles.

- Prudence: Manage the structure of the debt to protect the Government's fiscal position from unexpected increases in interest rates and to limit refinancing needs. Manage the Receiver General cash position to ensure that adequate liquidity is maintained at reasonable cost to the Government.
- Cost-effectiveness: Borrow using a variety of instruments, a range of maturities and a diversified investor base to be cost-effective.
- Maintaining a well-functioning market: Emphasize transparency, liquidity and regularity in the design and implementation of domestic debt programs in order to maintain a well-functioning domestic market. Work with market participants and regulators to enhance the integrity and attractiveness to investors of the market for Government of Canada securities.
- Consultations: Seek input from market participants on major adjustments to the federal debt and cash management programs.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

Foreign Reserves Management Objective

The objective of foreign reserves management is to maintain foreign currency liquidity, including funds needed to promote orderly conditions for the Canadian dollar in foreign exchange markets.

Foreign Reserves Management Principles

In pursuit of this objective, the Government of Canada manages its foreign exchange reserves according to a set of key principles.

- Prudence: Maintain an appropriate level of reserves invested in high-quality highly liquid assets. Manage reserves within a framework that matches foreign liabilities to reserve assets to immunize currency and interest rate risk, and that controls credit risk through diversification.
- Cost-effectiveness: Minimize the cost of carrying reserves (i.e. the difference between interest paid on foreign currency liabilities and the interest earned on reserve assets).
- Consultations: Seek input from market participants on major adjustments to the foreign reserves management program.
- Best practices: Ensure that the operational framework and practices are in line with the best practices of other comparable sovereign borrowers and the private sector.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government's fiscal policy sets the context for debt management operations. The Government recorded budgetary surpluses over the previous six fiscal years and reduced the federal debt (accumulated deficit) by \$52.3 billion. As announced in the March 2004 budget, the Government is committed to maintaining balanced budgets or better for 2003–04 and for each of the next two fiscal years.

Contingency Reserve and Debt Reduction

The Government of Canada sets aside an annual Contingency Reserve of \$3 billion to cover risks arising from unforeseen circumstances and variations in budget planning. The Contingency Reserve, if not needed, will be used to reduce federal debt.

Combined with forecast economic growth, the federal debt-to-GDP ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt (accumulated deficit) as a percentage of the economy is projected to fall to 42 per cent in 2003–04, down from its peak of 68.4 per cent in 1995–96. With the commitment to balanced budgets in each of the next two fiscal years, it is forecast to decline to about 38 per cent in 2005–06.

In terms of international debt burden comparisons, taking into account the accounting methods of various sovereigns, the debt burden of Canada's total government sector has declined the fastest among G-7 countries since the mid-1990s. Between 1995 and 2003, Canada's net financial liabilities as a percentage of GDP (akin to the debt-to-GDP ratio) declined by 34.3 percentage points. Consequently, Canada's total government debt burden moved from being the second highest among the G-7 countries to the second lowest in 2003. According to the OECD, Canada's debt burden is expected to be the lowest in the G-7 in 2004.

Financial Requirement/Source

The key budgetary measure for debt management planning is the financial requirement/source rather than the budgetary balance (see box on following page). The budgetary balance is presented on a full accrual basis, recognizing revenues and expenses when they are incurred. In contrast, the financial requirement/source is a cash flow measurement that represents actual cash transactions related to current- and prior-year budgetary items, as well as the cash implications of non-budgetary transactions, such as changes in financial or non-financial assets or liabilities.

***Measuring the Government's Fiscal Position:
Budgetary Balance and Financial Requirement/Source***

The budgetary balance and financial requirement/source measures used in the *Debt Management Strategy* are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

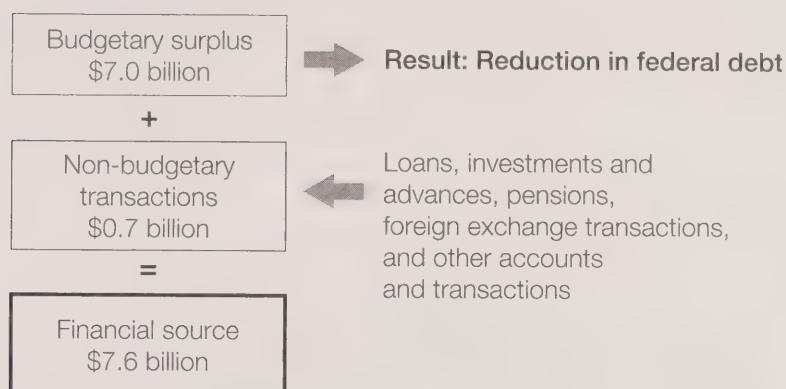
The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General of Canada, the Government moved to full accrual accounting in 2002–03. The move enhances transparency and decision making by providing a more complete accounting of government activities than under the previous modified accrual accounting framework. Under the full accrual basis of accounting, revenues and expenses are recorded when they are incurred, regardless of when the actual cash flows occur. For more information on accrual accounting, see Annex 6 of *The Budget Plan 2003*, available on the Department of Finance Web site at www.fin.gc.ca.

The financial requirement/source provides a measure of the net cash position of the Government. In contrast, the budgetary balance also includes obligations incurred by the Government during the course of the year for which the cash transaction does not take place until future years. In general terms, the difference between the financial requirement/source and the budgetary balance is timing (i.e. when funds for budgetary items are committed and the actual cash transaction occurs).

The financial requirement/source includes the cash outlays related to current- and prior-year budget commitments. It also includes transactions in loans, investments and advances, federal employees' pension accounts, other specified purpose accounts, foreign exchange activities, and changes in other financial assets, liabilities and non-financial assets. These activities are included as part of non-budgetary transactions. The financial requirement/source corresponds closely to the unified budget balance measure used in the United States.

Figure 1 presents the various elements of the Government's budgetary framework for the 2002–03 fiscal year, the last year for which audited Public Accounts financial statements are available.

Figure 1
Financial Source at March 31, 2003



Note: Numbers do not add up due to rounding.

Source: *Annual Financial Report of the Government of Canada* (fiscal year 2002–03), Department of Finance.

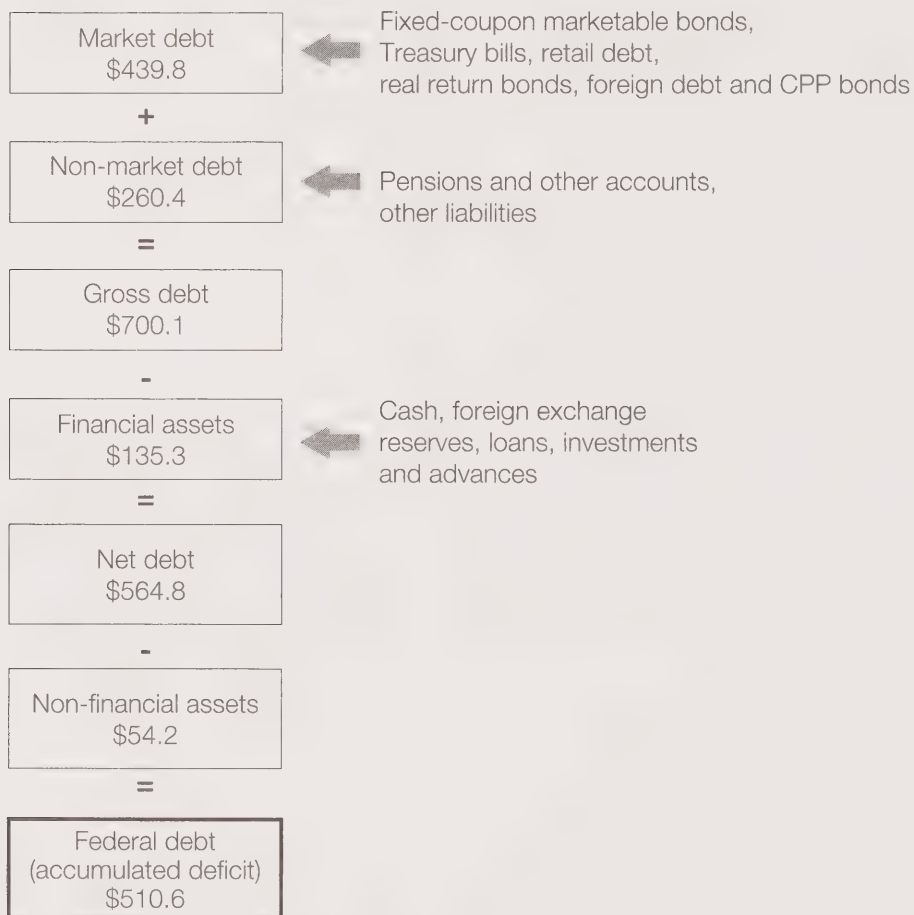
Net Financial Requirement/Source Outlook

For 2003–04 the Government expects a financial source of \$2.0 billion from non-budgetary transactions. The Government expects a financial requirement of \$4.5 billion in 2004–05. This is due to the transfer of Canada Pension Plan (CPP) operating balances, currently held by the Government, to the CPP Investment Board, as well as requirements from loans, investments and advances, and capital assets. The CPP funds transfer involves switching non-market debt to market debt, which engenders a cash requirement but does not have any effect on the federal debt.

Debt Composition

Debt management operations focus on the Government of Canada's market debt, which is only one component of the Government's gross debt. The other component of the gross debt, non-market debt, is taken into account in debt strategy planning but is not subject to debt management strategy initiatives. Non-market debt includes federal public sector pension liabilities and the Government's accrued liabilities. Debt strategy planning also focuses on the management of the Government's financial assets. Figure 2 illustrates the relationships between the components of the public debt for the 2002–03 fiscal year.

Figure 2
Total Public Debt as of March 31, 2003
 (in billions of dollars)

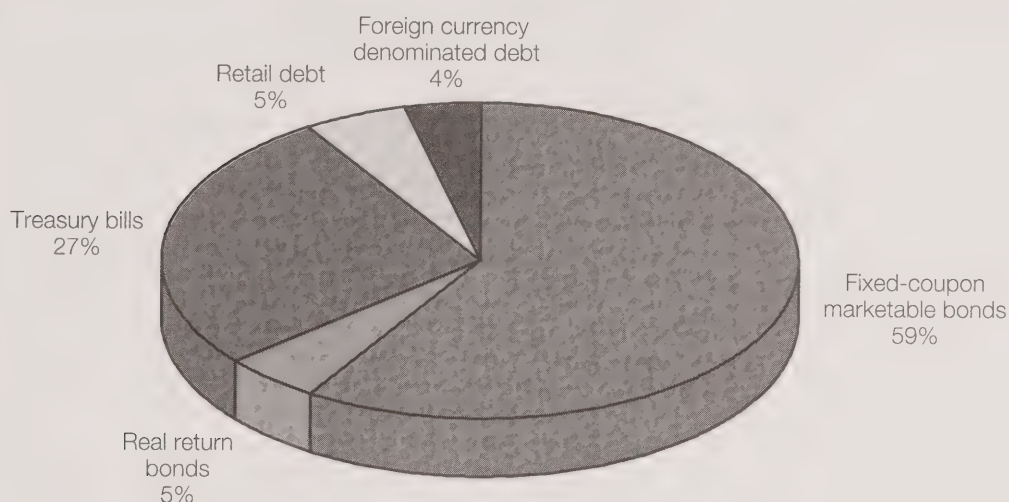


Note: Numbers may not add up due to rounding.

Source: *Annual Financial Report of the Government of Canada* (fiscal year 2002–03), Department of Finance.

The Government's market debt consists of fixed-coupon marketable bonds, real return bonds, Treasury bills, retail debt (Canada Savings Bonds, Canada Premium Bonds and Canada Investment Bonds), foreign currency denominated debt, as well as bonds issued to the Canada Pension Plan. Financial assets held by the Government include operating cash balances, loans, investments and advances, and foreign exchange reserves. Non-financial assets include land, buildings and infrastructure, and vehicles. Chart 1 shows the forecast composition of the market debt at year-end 2003–04.

Chart 1
Forecast Composition of Market Debt
March 31, 2004



Note: Excludes bonds issued to the Canada Pension Plan.
Source: Department of Finance.

Market Debt Outlook

The federal debt declined by \$7.0 billion in 2002–03 and by \$52.3 billion over the past six fiscal years. Market debt, the portion of the federal debt that is funded in capital markets, declined by \$2.5 billion in 2002–03 and by \$37.1 billion over the past six fiscal years. A further decline in market debt is expected in 2003–04.

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained to raise new market debt, in the form of a borrowing authority bill. Once obtained, the authority to raise debt levels generally extends through the remainder of the fiscal year and lapses at the start of the next fiscal year.

Currently available new borrowing authority is limited to a \$4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act. Given the impact of the expected transfer of the Canada Pension Plan operating balances, the Government may seek special borrowing authority to fund the transfer through the issuance of new market debt. The need for additional borrowing authority will be considered later in 2004–05, in light of the Government's prevailing fiscal position at that time.

2004–2005 Debt Management Strategy

Balancing Prudence and Cost: Debt Structure

One of the Government's key objectives in managing the debt is to strike the appropriate balance between low financing costs and cost stability. In general, borrowing long-term debt is less risky, but more costly, than borrowing short-term debt. The Government maintains a prudent debt structure to protect its fiscal position from unexpected increases in interest rates and to limit annual refinancing needs. One of the measures of prudence is the fixed-rate share of the debt—that is, the share of the debt that does not need to be refinanced within a year.

As announced in the 2003 budget, the Government has adopted a new target for the fixed-rate portion of the debt: it will be reduced from two-thirds to 60 per cent by 2007–08 to lower future debt costs. The Government is in a position to reduce the target following significant improvements in Canada's economic and fiscal position in recent years. Canada now has low and stable inflation, lower foreign indebtedness and a current account surplus, all of which make interest rate surprises less likely. In addition, the reduction in the debt level has provided Canada with greater financial stability, reduced vulnerability to events happening beyond our borders, and contributed to the restoration of Canada's triple-A credit rating. The reduction in the fixed-rate share will be implemented in an orderly and transparent manner to allow the market time to adjust to the required changes in debt programs.

As in past years, a simulation model has been used to re-evaluate the debt structure target. The analysis involves considering the potential debt costs and cost variation for a large number of interest rate scenarios. The analysis supports the reduction in the fixed-rate share to 60 per cent, indicating net annual cost savings could reach up to \$500 million, on average, when the 60-per-cent debt structure is in place, compared to the previous two-thirds target.

Compared to a two-thirds debt structure, the lower fixed-rate structure will raise the Government's short-term exposure to adverse movements in interest rates. For example, a 100-basis-point increase in interest rates along the entire yield curve would raise federal net debt-servicing costs by \$1.4 billion in the first year with a 60-per-cent fixed-rate structure, compared to \$1.1 billion for the current debt structure. By comparison, the impact of the same interest rate shock was estimated at \$1.8 billion in the mid-1990s.

However, the analysis also reconfirms that it is highly unlikely that the additional debt costs stemming from a severe interest rate shock would disrupt the budget plan in a given fiscal year due to the cushion built into the budgetary framework and Canada's lower debt level. Over time the additional costs of an interest rate shock would be more than offset by the savings associated with a lower fixed-rate structure.

The Government will continue to review the structure of the debt on an annual basis to determine whether adjustments are appropriate given the objectives of keeping costs low and maintaining market liquidity in a declining debt environment. Specifically, in 2004–05 the Government will evaluate the mix of net issuance among the four key bond maturities (2, 5, 10 and 30 years) and its impact on the average term to maturity and on costs. The potential for a better integration of debt management policies and the fiscal-planning framework will be examined to assess the utility and feasibility of setting a debt structure target that aids in the management of the overall budget balance.

Maintaining A Well-Functioning Market

As the sovereign and the largest borrower in the Canadian fixed-income marketplace, the Government has a major interest in sustaining a liquid and efficient market for Government of Canada securities for the purpose of providing stable low-cost funding. A liquid and efficient government securities market also provides key pricing and hedging tools for market participants, thereby contributing to the effective functioning of the broader fixed-income market.

In developing its debt program plans, the Government conducts extensive consultations with market participants. In developing the debt management strategy for 2004–05, the Government consulted with market participants on two occasions: once on issues related to the Government's real return bond program and once on wider issues related to the debt program. The results of these consultations are incorporated in the following section, which describes detailed initiatives being undertaken in 2004–05 to maintain and enhance operational effectiveness in the areas of domestic debt, cash and reserves management. For further information, detailed reports on topics of discussion and views received from market participants are posted on the Bank of Canada's Web site at www.bankofcanada.ca.

As in past years, the Government plans to consult further with market participants on potential adjustments to debt program plans during the 2004–05 fiscal year. Discussion papers and reports on these future consultations will be posted on the Bank of Canada's Web site following the consultations.

2004–2005 Debt Strategy Action Plan and Intended Results

Debt Structure

Objective: Gradually reduce the fixed-rate share of debt from two-thirds to 60 per cent by 2007–08.

Action for 2004–05:

- Continue to reduce the fixed-rate share of debt towards the 60-per-cent target.
- Increase the size of the Treasury bill program from \$110 billion–\$115 billion in 2003–04 to approximately \$130 billion in 2004–05.
- Issue about \$36 billion of bonds in 2004–05, \$4 billion less than in 2003–04. Due to large bond maturities and continued cash management bond buyback operations, the bond stock is expected to decrease by some \$16 billion.
- Continue bond buybacks at a planned level of about \$11 billion, as in 2003–04.
- Maintain a stable maturity profile.

Intended Result:

- ➔ Achieve lower debt charges, while continuing to prudently mitigate the risk to the budget framework.
- ➔ Facilitate market adjustment to changes in the bond and Treasury bill programs.
- ➔ Limit the need to refinance a large portion of debt in any given period and help maintain stability in debt programs over time.

Domestic Debt Programs

Objective: *Maintain diversified sources of funding and a well-functioning market.*

Action for 2004–05:

Continue regular issues of marketable bonds in four maturity sectors, Treasury bills in three maturity sectors and a long-dated index-linked bond.

Continue to borrow on a pre-announced basis, seek input from market participants on major adjustments to programs, and provide timely notices of government policy decisions.

Maintain current benchmark target sizes for 2-, 5-, 10- and 30-year bonds.

Maintain issuance of real return bonds, with issuance equal to or marginally higher than in previous years.

Beginning April 1, 2004, change turnaround time for auctions and buybacks to a best efforts basis.

Expand the basket of bonds eligible for 10-year cash and switch buybacks to include more longer-dated maturities.

Maintain the switch buyback program on an ongoing basis.

Maintain the pilot 10:30 a.m. timing for Treasury bill auctions and 11:15 a.m. timing for cash management bond buybacks on an ongoing basis.

Intended Result:

➔ Keep costs low and mitigate funding risk by diversifying borrowing across investor segments, instruments and maturities.

➔ Maintain transparency and efficiency.

➔ Maintain a liquid market for on-the-run issues and building-benchmark issues.

➔ Continue the Government's commitment to the real return bond program to help diversify its product and investor base on a cost-effective basis.

➔ Enhance the bidding process and participation.

➔ Promote liquidity by reaching target benchmark sizes within a one-year cycle.

➔ Promote liquidity by helping build benchmarks within a reasonable time frame.

➔ Support participation in these operations.

Foreign Reserves and Debt Programs

Objective: *Improve the cost-effectiveness of funding foreign reserve assets.*

Action for 2004–05:

- Continue to use cross-currency swaps for the majority of reserves funding.

Intended Result:

- ➔ Keep the cost of carrying reserve assets low.

2004–2005 Debt Strategy Plan

Domestic Debt Programs

Modifications to debt programs in 2004–05 will continue the orderly adjustment toward the new debt structure target. In this context, the Government will focus on the maintenance of a well-functioning market.

In particular, starting April 1, 2004, the Government will reduce the turnaround time for auctions and buyback operations from a fixed time to a “best efforts basis” (i.e. when ready). Turnaround times for auctions and buybacks are expected to decline to about 5 and 10 minutes respectively. Release times will vary from operation to operation, subject to a maximum turnaround time for auctions and buybacks of 10 and 15 minutes respectively. The Government will continue to take steps in the fiscal year to streamline these operations to further reduce turnaround times. Reducing the turnaround time will reduce the market risk for market participants, further enhancing the efficiency of the auction and buyback process. Market participants support this change in turnaround time.

Fixed-Coupon Marketable Bond Program

Gross bond program issuance in 2004–05 is planned to be about \$36 billion, \$4 billion less than in 2003–04. Net bond issuance of about \$25 billion will also be moderately lower than in 2003–04. Taking into account bond maturities and cash management bond buyback operations during the year, the stock of bonds is expected to decline from \$257 billion to about \$241 billion.¹

In 2004–05 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds. As in previous years, a quarterly calendar of auctions will be posted on the Bank of Canada Web site before the start of each quarter.

The 2-, 5-, 10- and 30-year benchmark target sizes will remain unchanged from last year (2-year bonds: \$7 billion to \$10 billion, 5-year bonds: \$9 billion to \$12 billion, 10-year bonds: \$10 billion to \$14 billion, and 30-year bonds: \$12 billion to \$15 billion). The benchmark sizes will be achieved through reopenings (where a particular bond issue is sold at several auctions) and switch buyback operations until the benchmark target size is reached.

During the recent round of debt strategy consultations, market participants suggested that the sizes of nominal bond auctions are approaching their lower limit, particularly in the 10- and 30-year maturities, and that structural adjustments to the bond program may be required in the years ahead.

¹ Regular bond buybacks do not affect the stock of bonds, as the program supports the issuance of new benchmark bonds.

A list of outstanding Government of Canada bonds, including their maturity dates, is contained in the 2002–03 *Debt Management Report*, which is available on the Department of Finance Web site at www.fin.gc.ca. The list will also be available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be posted on the Bank of Canada's Web site at www.bankofcanada.ca.

Bond Buyback Program

The Government conducts two types of bond buyback operations: regular bond buybacks and cash management bond buybacks. Regular bond buybacks permit the maintenance of a liquid new bond issue program by buying existing bonds with a remaining term to maturity from 1 to 25 years. These buyback operations are sizeable and play a strategic role in maintaining an active new issue bond program. The second kind of buyback program, cash management bond buybacks, aids in the management of the Government's cash balances by repurchasing bonds maturing within the next 18 months.

Regular Bond Buyback Operations

Bond buyback operations can be conducted on a cash or switch basis. Bond buyback operations on a cash basis involve the exchange of less liquid bonds for cash and are conducted shortly after auctions of similar maturity bonds. Bond buyback operations on a switch basis involve the exchange of less liquid bonds for new issue bonds on a duration-neutral basis and are conducted at other times in each quarter.

Consultations with market participants indicated broad support for both the cash and switch buyback programs as a way of helping to maintain liquidity and new issuance of Government of Canada securities. Market participants suggested that it might be increasingly difficult to conduct large-scale buyback operations in the future due to the shrinking pool of eligible bonds to buy back.

The Government plans to conduct about \$11 billion in bond buyback operations in 2004–05, similar to 2003–04. The amount of buybacks on a switch basis will be decreased by approximately \$1 billion to roughly \$4 billion, while cash buybacks will be increased by about \$1 billion to nearly \$7 billion. The quarterly maximum repurchase target amounts for the regular bond buyback program and the timing of each operation will be announced through the quarterly bond auction calendar published by the Bank of Canada at www.bankofcanada.ca.

To supplement buyback operations in the 10-year sector, starting April 1, 2004, bonds included in the basket of eligible bonds for buyback operations in the 30-year sector will also be included in the basket of eligible bonds for buyback operations in the 10-year sector.

To broaden participation in buyback operations, buybacks on a switch basis were introduced on a pilot basis in December 2001 with the first operation conducted in February 2002. During debt strategy consultations, market participants expressed strong support for the switch program. From the Government's perspective, the program is successfully meeting its objectives and, therefore, it will be maintained on an ongoing basis.

Cash Management Bond Buybacks (CMBBs)

To reflect market participants' preference for CMBB operations to follow Treasury bill auctions, the timing of CMBB operations was moved from 10:30 a.m. to 11:15 a.m. on a trial basis effective June 17, 2003. Based on positive comments received during 2004–05 debt strategy consultations, this timing will be maintained on an ongoing basis.

Real Return Bonds (RRBs)

In light of the evolution in the macroeconomic environment and the consequent change in the target debt structure to a lower fixed-rate share, the Government announced in the 2003–04 *Debt Management Strategy* that it would assess the RRB program as a method of funding for the Government of Canada.

Over the 2003–04 fiscal year, the Department of Finance and the Bank of Canada examined both the program's performance in achieving its stated objectives and the program's future value in the domestic debt program.

In addition to the internal review the Government sought the views of market participants on the RRB program. The Bank of Canada published a consultation document² and a cost-effectiveness study.³ During consultations the Government spoke with over 50 different parties, including institutional investors, primary dealers and pension consultants. The Government also received a number of comments from various interested parties via e-mail. A summary of these consultations was published on the Bank of Canada Web site.⁴

The review found that the program has generally fulfilled its stated objectives. It found that global sovereign issuance of inflation-indexed securities has increased in recent years and that demand for RRBs continues. In the context of ongoing debt program adjustments, continued RRB issuance levels at around current levels over the next few years should not be an immediate constraint on maintaining issuance levels in nominal bond sectors and would have very little effect on the move to a lower fixed-rate share.

As a result of the review, the Government will maintain the RRB program, with expected issuance equal to or marginally higher than the \$1.4 billion issued in 2003–04.

² See http://www.bankofcanada.ca/en/notices_fmd/consult03.htm.

³ See http://www.bankofcanada.ca/en/notices_fmd/rrb2003.htm.

⁴ See http://www.bankofcanada.ca/en/notices_fmd/market_consult03.htm.

Treasury Bill Program

Based on the budget outlook and plans for attaining the 60-per-cent target for the fixed-rate portion of the debt, the stock of Treasury bills is expected to increase by \$15 billion-\$20 billion to about \$130 billion by the end of 2004-05.

To encourage participation by a broader range of market participants and to reflect market participants' preferences, the timing of Treasury bill auctions was changed from 12:30 p.m. to 10:30 a.m. effective June 17, 2003. Based on positive comments received during the 2004-05 debt strategy consultations, this timing will be maintained on an ongoing basis.

Cash management bills (i.e. short-dated Treasury bills) help the Government manage its cash requirements in an efficient manner. The Government intends to continue to actively use cash management bills in 2004-05.

Domestic Market Development

The Department of Finance and the Bank of Canada have an ongoing dialogue with market participants and regulators on the development of the fixed-income market in Canada. Discussions are expected to continue to focus on the development and regulation of electronic trading systems in fixed-income securities. Electronic trading systems, which have recently appeared in Canada, have the potential to improve the transparency and efficiency of the market.

Retail Debt Program

In 2004-05 the Government will continue to focus on cost reduction, keeping the non-marketable retail debt portfolio and costs aligned with a declining debt environment. Retail debt instruments are available through financial institutions, through employer sponsoring organizations, and directly by telephone or through the Canada Investment and Savings Web site at www.csb.gc.ca.

Management of the Government's Cash Balances

The Government of Canada manages its cash balances in order to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. The cash balances are invested through auctions twice daily.

The bulk of the cash balances are invested through a morning auction. The Government implemented a new framework in September 2002 to bring its operations in line with the best practices of other governments and market participants.

Under the new framework, the morning auction incorporates a credit management system, using credit ratings, credit lines and collateral arrangements to manage credit risk, and a broad list of eligible counterparties to encourage more competitive bidding at the auctions.

The afternoon auction is used to invest the Government's residual cash balances. This auction is uncollateralized and is limited to Large Value Transfer System participants.

No major change is planned to the cash management framework in 2004–05.

Foreign Reserves Debt Programs

The Government holds foreign exchange reserve assets in the Exchange Fund Account to provide foreign currency liquidity and to provide the funds needed to help promote orderly conditions for the Canadian dollar in the foreign exchange markets. Further details on the management of international reserves are available in the *Annual Report to Parliament on the Operations of the Exchange Fund Account*, which is available on the Department of Finance Web site at www.fin.gc.ca.

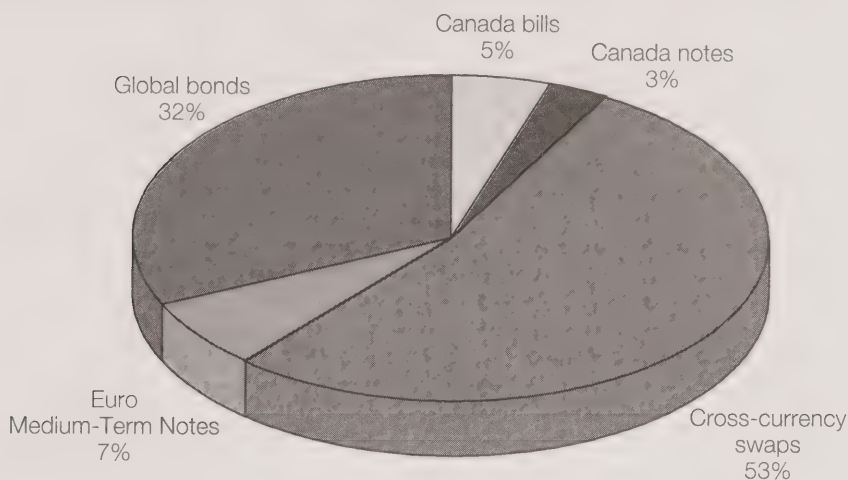
The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis, based on many of the same principles used by other sovereigns and private sector financial institutions, including prudent risk management principles.

Funding Sources

The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar paper program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps have proven to be a particularly cost-effective alternative and have been actively used in recent years.

In 2004–05 the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign currency denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations will continue to be the primary source of reserve funding. Chart 2 shows the expected composition of foreign currency liabilities at March 31, 2004.

Chart 2
Forecast Composition of Foreign Currency Liabilities
March 31, 2004



Source: Department of Finance.

Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. Standards for risk control are high, market risks are immunized and high standards of credit quality and portfolio diversification are followed.

The Government's risk management policies call for prudent management of treasury risks based on best practices. In recent years the Government has continued to further strengthen its risk management framework by implementing collateral management frameworks for its Receiver General AM auctions, cross-currency swap program, and US-dollar deposit program. Collateral management systems are increasingly the norm in capital markets as a way of managing risk. Under the frameworks, high-quality collateral (e.g. cash, securities) is posted to the Government when its credit exposure to financial institution counterparties exceeds specified limits.

Glossary

accumulated deficit: Total liabilities less financial and non-financial assets.

asset liability management: A systemic investment decision-making framework that is used to concurrently manage a portfolio of assets and liabilities.

average term to maturity: The average time remaining before debt matures, taking only principal amounts into account.

basis point: One-hundredth of a percentage point (0.01 per cent).

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenses. A deficit is the shortfall between government revenues and budgetary expenses.

buyback on a cash basis: The repurchase of bonds for cash. Used to maintain the size of auctions and new issuance.

buyback on a switch basis: The exchange of outstanding bonds for new bonds in the current building benchmark.

Canada bill: Promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserve funding purposes only.

Canada Premium Bond: A non-marketable security instrument issued by the Government of Canada, which is redeemable once a year on the anniversary date or during the 30 days thereafter without penalty.

Canada Savings Bond: A non-marketable security instrument issued by the Government of Canada, which is redeemable on demand by the registered owner(s), and which, after the first three months, pays interest up to the end of the month prior to cashing.

Contingency Reserve: Is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and unpredictable events. If not needed, it is used to pay down the public debt.

Cost at Risk: A measure based on the statistical distribution of debt charges that enables risk to be quantified in terms of the maximum costs that could occur within a specified probability range in a particular year.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

electronic trading system: An electronic system that provides real-time information about securities and enables the user to execute financial trades.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar in the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

financial requirement/source: Measures the difference between cash coming in to the Government and cash going out. In the case of a financial requirement, if cash on hand is not used, it is the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fixed-coupon marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fungible bond: A bond that has the same financial attributes as another. Fungible bonds are interchangeable.

government securities distributor: Member of a group of investment banks and dealers, through which the Government distributes Government of Canada Treasury bills and marketable bonds.

gross public debt: Total amount the Government owes. It consists of market debt in the form of outstanding securities such as Treasury bills, marketable bonds and Canada Savings Bonds, non-market debt owed mainly to the superannuation accounts for government employees, and other current liabilities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

marketable debt: Market debt that is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets, and consists of marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds), foreign currency denominated bonds and bills, as well as bonds issued to the Canada Pension Plan.

market transparency: Within the context of debt management, characterization of a bond market where debt management strategies and operations are known and well understood by market participants.

net debt: Gross debt, net of financial assets.

non-marketable debt: Market debt that is not tradeable and that is issued to retail investors (Canada Savings Bonds and Canada Premium Bonds).

non-market debt: Consists of the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest payments and payments of matured debt).

primary market: The market in which securities are initially sold or offered.

real return bond (RRB): Government of Canada RRBs pay semi-annual interest based upon a real interest rate. Unlike standard fixed-coupon marketable bonds, interest payments on RRBs are adjusted for changes in the Consumer Price Index.

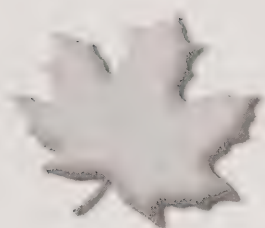
secondary market: The market in which previously issued securities are traded, as distinguished from the new issue or primary market.

sovereign market: Market for the debt issued by a government.

Treasury bill: Short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6 or 12 months are currently auctioned on a biweekly basis.

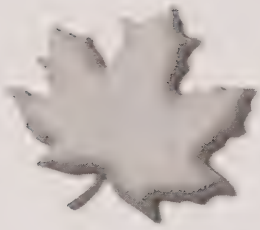
turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

yield curve: Graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.



DEBT MANAGEMENT STRATEGY

2005–2006



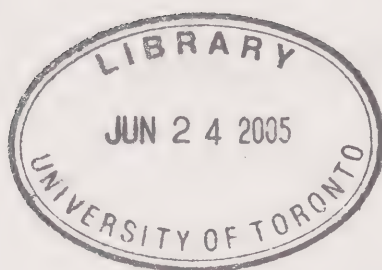
DEBT MANAGEMENT STRATEGY

2005–2006



Department of Finance
Canada

Ministère des Finances
Canada



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Foreword by the Minister of Finance

I am pleased to table before Parliament the Government of Canada's *Debt Management Strategy* for fiscal year 2005–06. This document provides comprehensive information on the Government's debt strategy and objectives for the coming fiscal year.

Over the past eight years, Canada has pursued a balanced approach to fiscal management that has combined debt reduction, targeted spending in areas that represent the priorities of Canadians, and efforts to reduce the tax burden on both individuals and businesses. This balanced approach has been the cornerstone of Canada's fiscal policy and has been the source of our success at a time when many of our G-7 counterparts continue to face difficult fiscal circumstances.

This balanced approach has provided significant benefits for Canadians. Our most recent federal budget, which was tabled on February 23, 2005, forecasts that Canada will record its eighth consecutive balanced budget or better—a record that is unmatched in our nation's history. Since 1997–98, the budgetary surpluses have reduced our federal debt by more than \$61 billion. As a result, the federal debt-to-GDP (gross domestic product) ratio is projected to decline to 38.8 per cent in 2004–05, down from 68.4 per cent in 1995–96. This reduction in the federal debt burden has led to lower interest charges of more than \$3 billion annually, savings that have already been invested in the priorities of Canadians, such as health care, education and the environment, as well as significant reductions in both corporate and personal tax rates.

Nevertheless, federal debt charges continue to consume just under 18 cents out of every revenue dollar received by the federal government. In order to provide the funding necessary to meet the priorities of Canadians, while preparing for the demographic and social challenges caused by an aging population, the Government must continue to maintain its focus on debt reduction and prudent fiscal planning.

Canadians continue to enjoy one of the highest standards of living in the world, and the Government is committed to maintaining our nation's prosperity. By continuing to use a balanced approach that combines targeted spending, debt reduction and prudent management of our debt, and tax relief, we will redouble our efforts to ensure that Canada continues to enjoy a strong economy, both now and in the future.

The Honourable Ralph Goodale, P.C., M.P.
Minister of Finance
Ottawa, March 21, 2005

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance Canada that provides information on the Government of Canada's objectives and strategies for managing the outstanding stock of market debt and financial assets within the context of the fiscal environment.

The Department publishes a companion document, the *Debt Management Report*, which reports on the Government's debt operations over the previous fiscal year and provides detailed information on outstanding debt. This publication is available shortly after the release of the Public Accounts each year.

Focus of the Federal Debt Strategy

The debt strategy focuses on the management of the marketable debt and liquid financial assets of the Government of Canada.

As of March 31, 2004, the Government had \$440.2 billion of market debt composed of marketable bonds, Treasury bills, retail debt, foreign currency debt, Canada Pension Plan bonds, and obligations related to capital leases, and \$61.7 billion of liquid financial assets composed of domestic cash balances and foreign exchange assets.

	(C\$ billions)
Market Debt	
<i>Payable in Canadian currency</i>	
Marketable bonds	278.8
(fixed-rate bonds with 2-, 5-, 10- and 30-year maturities and real return bonds with 30-year maturities)	
Treasury bills	113.4
(zero-coupon securities with 3-, 6- and 12-month maturities)	
Retail debt	21.3
(Canada Savings Bonds and Canada Premium Bonds)	
Canada Pension Plan bonds	3.4
Obligations related to capital leases	2.8
<i>Payable in foreign currency</i>	
Marketable bonds	12.9
(fixed-rate bonds issued in US dollars and in other currencies)	
Canada bills	3.4
(zero-coupon securities with 1- to 9-month maturities)	
Foreign currency notes	4.3
(Canada notes and Euro Medium-Term Notes)	
Liquid Financial Assets	
Cash	20.5
Foreign exchange reserves	41.2

Source: *Public Accounts of Canada*.

Highlights of the 2005–2006 Debt Strategy

- The Government will continue to target a gradual reduction in the fixed-rate share of the debt from two-thirds in 2002–03 to 60 per cent in 2007–08 to achieve savings on public debt charges while retaining a prudent debt structure.
- In moving to the new debt structure, the maintenance of a well-functioning market in Government of Canada securities is an important objective of the debt strategy.
- Thus, the change in the debt structure will continue to be made gradually through increases in the Treasury bill program and reductions in the bond program:
 - The outstanding amount of Treasury bills will increase from about \$130 billion at the end of 2004–05 to approximately \$140 billion by the end of 2005–06.
 - The total amount of marketable bonds issued in 2005–06 will be about \$33 billion, roughly \$3 billion lower than in 2004–05. Net marketable bond issuance (net of buybacks) of about \$23 billion will be about \$1 billion lower than in 2004–05. The Government intends to forego the auction of a 2-year fungible bond in the fourth quarter of 2005–06 to facilitate a reduction in gross bond issuance in the coming year.
 - The bond buyback program has helped to smooth the transition from the larger bond programs of the 1990s to the smaller programs expected in the future. While the bond buyback program is needed to continue to support a portion of gross bond issuance over the next few years, the requirement for a transition mechanism to a sustainable, lower level of bond issuance is diminishing. In addition, it is appropriate to reduce the buyback program as the bond stock becomes concentrated in fewer liquid issues. The Government will begin in 2005–06 to reduce the size of the bond buyback program. The planned amount of bond buybacks is in the order of \$9 billion to \$10 billion, roughly \$1.5 billion less than in 2004–05.
 - The stock of marketable domestic bonds will decrease from an estimated \$243 billion at the end of 2004–05 to about \$235 billion due to maturities and continued cash management buyback operations.
- Annual bond issuance is expected to stabilize in the range of \$30 billion to \$35 billion once the 60-per-cent fixed-rate target has been reached. Annual issuance of this size will put into question the viability of the scope and structure of the current bond program. In 2005–06, the Government will consult with market participants on potential changes to the structure of the bond program to help ensure that a well-functioning market for Government of Canada securities is maintained in future years.

To enhance bidding and participation in domestic debt operations:

- Reflecting market participants' preferences, the timing of bond auctions will be advanced from 12:30 p.m. to 12:00 p.m. to allow these auctions and associated buyback operations to take place earlier in the day. Also, the time between bond auctions and cash buybacks will be reduced from 30 minutes to 20 minutes beginning in April. The offering deadline for bond buybacks will be advanced from 1:00 p.m. to 12:20 p.m.
 - The Government will continue to work in the fiscal year to further reduce turnaround times for auctions and buyback operations.
- The Government will be actively working with market participants and securities regulators in 2005–06 to increase the level of transparency of secondary market trading information for Government of Canada securities, both for institutional and retail investors.

Funds Management Framework

Government of Canada funds management encompasses a wide range of activities related to the issuance of debt and the management of liquid financial assets by the Government. Prudent and effective funds management is a key element of achieving the Government's objective of fiscal sustainability. Management of debt and assets follows key principles. There are also specific objectives and principles guiding management of domestic debt and cash, and management of foreign reserves.

Key Principles

- Governance: Ensure that debt and asset management activities are conducted in line with clearly established operational and risk guidelines and that risk monitoring and oversight are independent of treasury management operations.
- Transparency: Disclose information on the management and performance in a timely manner so as to ensure public understanding and accountability.
- Leading practices: Operational frameworks and practices should be in line with leading practices of other comparable sovereigns. Regular evaluations should be conducted of the effectiveness of the governance framework, policy initiatives and operations.

Domestic Debt and Cash Management

Objectives

The fundamental objective of domestic debt and cash management is to provide stable, low-cost funding to meet the financial obligations and liquidity needs of the Government of Canada. Key strategic objectives, pursued over a medium-term horizon, are to maintain a prudent debt structure, maintain and enhance a well-functioning market for Government of Canada securities, and maintain a diversified investor base.

Principles

In pursuit of these objectives, the Government of Canada manages its activities according to a set of principles.

- Prudence: Manage the structure of the debt to protect the Government's fiscal position from unexpected increases in interest rates and to limit refinancing needs. Manage the Receiver General cash position to ensure that adequate liquidity is maintained at reasonable cost and risk to the Government.
- Cost-effectiveness: Borrow using a variety of instruments and a range of maturities, and maintain a diversified investor base.

- Maintaining a well-functioning market: Emphasize transparency, liquidity and regularity in the design and implementation of domestic debt programs in order to maintain a well-functioning domestic market. Work with market participants and regulators to enhance the integrity and attractiveness to investors of the market for Government of Canada securities.
- Consultations: Seek input from market participants on major adjustments to the federal debt and cash management programs.

Foreign Reserves Management

Objectives

The fundamental objective of foreign reserves management is to provide a source of funds to help promote orderly conditions for the Canadian dollar in the foreign exchange market, and to provide general foreign currency liquidity for the Government.

The key strategic objectives of foreign reserves management are to maintain a high standard of liquidity, preserve capital value, and optimize return subject to liquidity and prudence objectives.

Principles

In pursuit of these objectives, the Government of Canada manages its foreign exchange reserves according to a set of principles.

- Prudence: Manage borrowing and investment activities to limit exposure to risk and protect the value of the Government's reserve assets.
- Cost-effectiveness: The carrying cost of reserves, taking into account the return on assets and the cost of liabilities, should be kept as low as possible.

Debt Management Environment

Fiscal Outlook

Budgetary Balance

The Government's fiscal policy sets the context for debt management operations. The Government recorded budgetary surpluses over the previous seven fiscal years and reduced the federal debt (accumulated deficit) by \$61.4 billion. As announced in the February 2005 budget, the Government is committed to maintaining balanced budgets or better for 2004–05 and for each of the next five fiscal years.

Contingency Reserve and Debt Reduction

The Government of Canada sets aside an annual Contingency Reserve of \$3 billion to cover risks arising from unforeseen circumstances.

Combined with forecast economic growth, the federal debt-to-GDP ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt (accumulated deficit) as a percentage of the economy is projected to fall to 38.8 per cent in 2004–05, down from its peak of 68.4 per cent in 1995–96. With the commitment to balanced budgets in each of the next five fiscal years, it is forecast to decline to about 30.6 per cent in 2009–10.

In terms of international debt burden comparisons, taking into account the accounting methods of various sovereigns, the debt burden of Canada's total government sector has declined the fastest among Group of Seven (G-7) countries since the mid-1990s. Between 1995 and 2004, Canada's net financial liabilities as a percentage of GDP (akin to the debt-to-GDP ratio) are estimated to have been reduced by 38.2 percentage points. Consequently, Canada's total government debt burden moved from being the second highest among the G-7 countries to the lowest in 2004. According to the OECD, Canada's debt burden is expected to decline further in both 2005 and 2006, while the debt burdens of the other G-7 countries, with the exception of Italy, will increase.

Financial Requirement/Source

The key budgetary measure for debt management planning is the financial requirement/source rather than the budgetary balance (see box below). The budgetary balance is presented on a full accrual basis, recognizing revenues and expenses when they are incurred. In contrast, the financial requirement/source is a cash flow measurement that represents actual cash transactions related to current- and prior-year budgetary items, as well as the cash implications of non-budgetary transactions, such as changes in financial or non-financial assets or liabilities.

Measuring the Government's Fiscal Position: Budgetary Balance and Financial Requirement/Source

The budgetary balance and financial requirement/source measures used in the *Debt Management Strategy* are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

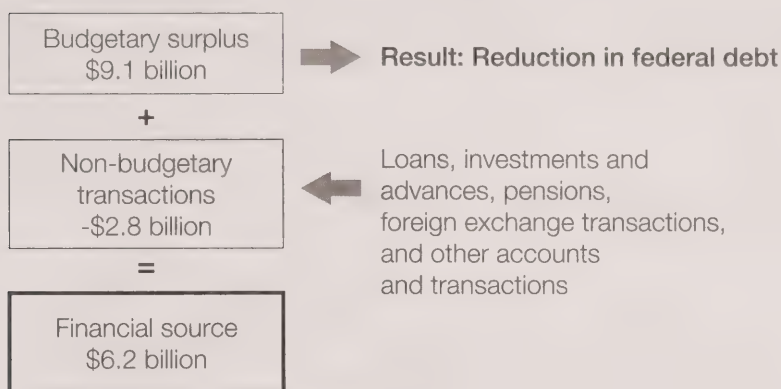
The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General of Canada, the Government moved to full accrual accounting in 2002–03. The move enhances transparency and decision making by providing a more complete accounting of government activities than under the previous modified accrual accounting framework. Under the full accrual basis of accounting, revenues and expenses are recorded when they are incurred, regardless of when the actual cash flows occur. For more information on accrual accounting, see Annex 6 of *The Budget Plan 2003*, available on the Department of Finance Web site at www.fin.gc.ca.

The financial requirement/source provides a measure of the net cash position of the Government. In contrast, the budgetary balance also includes obligations incurred by the Government during the course of the year for which the cash transaction does not take place until future years. In general terms, the difference between the financial requirement/source and the budgetary balance is timing (i.e. when funds for budgetary items are committed and the actual cash transaction occurs).

The financial requirement/source includes the cash outlays related to current- and prior-year budget commitments. It also includes transactions in loans, investments and advances, federal employees' pension accounts, other specified purpose accounts, foreign exchange activities, and changes in other financial assets, liabilities and non-financial assets. These activities are included as part of non-budgetary transactions. The financial requirement/source corresponds closely to the unified budget balance measure used in the United States.

Figure 1 presents the various elements of the Government's budgetary framework for the 2003–04 fiscal year, the last year for which audited Public Accounts financial statements are available.

Figure 1
Financial Source at March 31, 2004



Note: Numbers do not add due to rounding.
Source: *Public Accounts of Canada*.

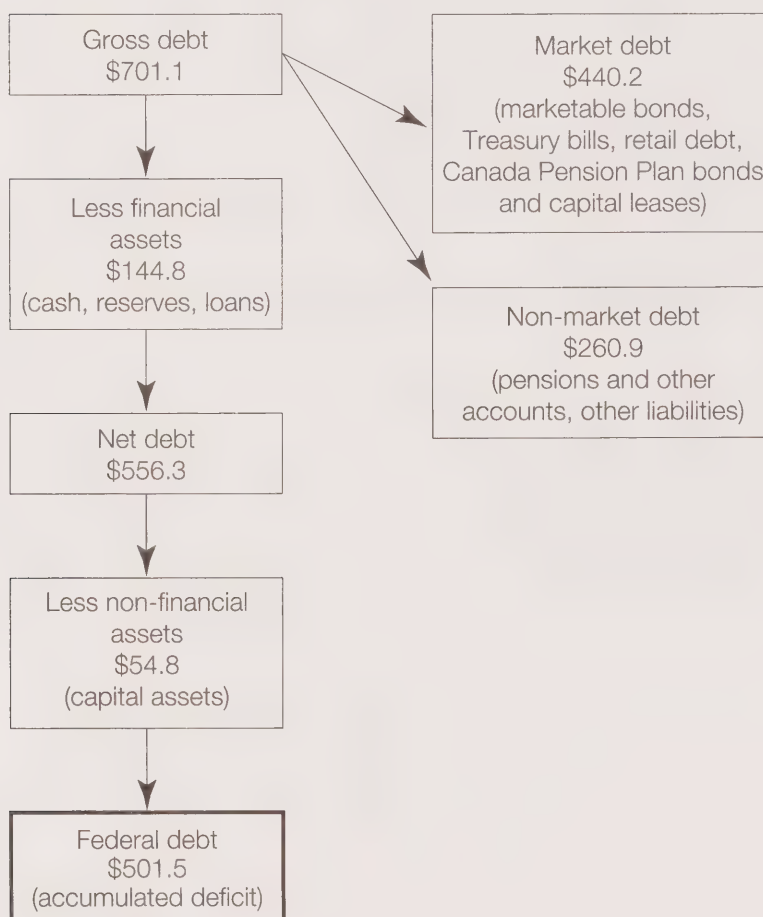
Net Financial Requirement/Source Outlook

With a balanced budget and a requirement of \$2.7 billion in non-budgetary transactions, a financial requirement of \$2.7 billion is estimated in 2004–05. The Government also expects a financial requirement of \$5.3 billion in 2005–06. This is due to the transfer of Canada Pension Plan (CPP) operating balances, currently held by the Government, to the CPP Investment Board, as well as requirements from loans, investments and advances, and capital assets. The CPP funds transfer involves switching non-market debt to market debt, which engenders a cash requirement but does not have any effect on the federal debt.

Debt Composition

Debt management operations focus on the Government of Canada's market debt, which is only one component of the Government's gross debt. The other component of the gross debt, non-market debt, is taken into account in debt strategy planning but is not subject to debt management strategy initiatives. Non-market debt includes federal public sector pension liabilities and the Government's accrued liabilities. Debt strategy planning also focuses on the management of the Government's financial assets. Figure 2 illustrates the relationships between the components of the public debt for the 2003–04 fiscal year.

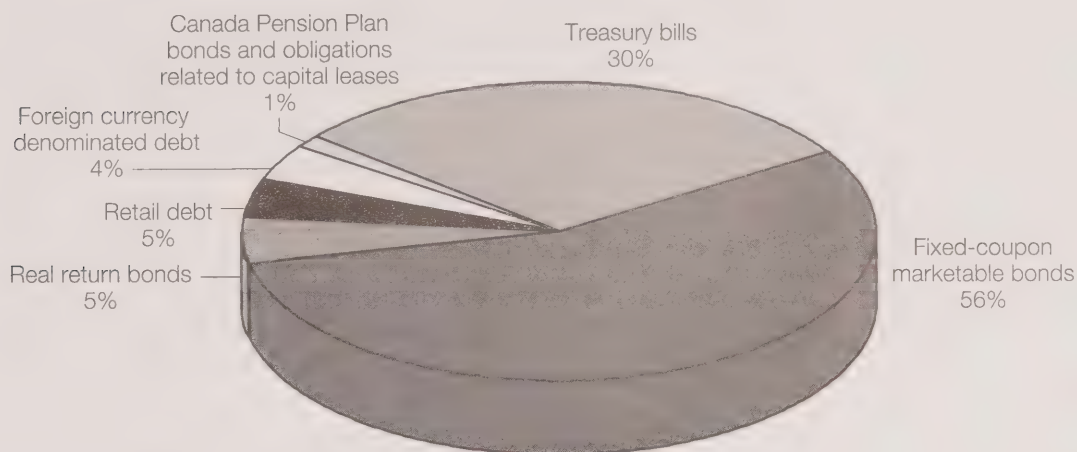
Figure 2
Total Public Debt at March 31, 2004
 (in billions of dollars)



Source: *Public Accounts of Canada*.

The Government's market debt consists of fixed-coupon marketable bonds, real return bonds, Treasury bills, retail debt (Canada Savings Bonds and Canada Premium Bonds), foreign currency denominated debt, and bonds issued to the Canada Pension Plan and obligations related to capital leases. Financial assets held by the Government include operating cash balances, loans, investments and advances, and foreign exchange reserves. Non-financial assets include land, buildings and infrastructure, and vehicles. Chart 1 shows the forecast composition of the market debt at year-end 2004–05.

Chart 1
Forecast Composition of Market Debt
March 31, 2005



Note: Does not add to 100% due to rounding.
 Source: Department of Finance.

Market Debt Outlook

The federal debt declined by \$9.1 billion in 2003–04 and by \$61.4 billion over the past seven fiscal years. Market debt, the portion of the federal debt that is funded in capital markets, declined by \$2.2 billion in 2003–04 and by \$38.6 billion over the past seven fiscal years. A further decline in market debt is expected in 2004–05.

Borrowing Authority

Under the Financial Administration Act, the Government has standing authority to refinance market debt maturing in a fiscal year.

Parliamentary approval must be obtained to raise new market debt, in the form of a borrowing authority bill. Once obtained, the authority to raise debt levels generally extends through the remainder of the fiscal year and lapses at the start of the next fiscal year.

Currently available borrowing authority is limited to a \$4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act. The Government expects to meet forecast financial requirements in 2005–06 without seeking new borrowing authority.

2005–2006 Debt Management Strategy: Themes

Balancing Prudence and Cost: Debt Structure

One of the Government's key objectives in managing the debt is to strike the appropriate balance between low financing costs and cost stability over a medium-term horizon. In general, borrowing long-term debt is less risky, but more costly, than borrowing short-term debt. Given its sizeable level of debt, the Government maintains a prudent debt structure to protect its fiscal position from unexpected increases in interest rates and to limit annual refinancing needs. One of the main targets in this regard is the fixed-rate share of the debt—that is, the share of the debt that does not need to be refinanced within a year.

In 2005–06, the Government will continue to manage the transition by 2007–08 from two-thirds to the new 60-per-cent target, adopted in the 2003 budget, for the fixed-rate portion of the debt. The reduction in the fixed-rate share is being implemented in an orderly and transparent manner to allow the market time to adjust to the required changes in debt programs.

Updated analysis continues to support the reduction in the fixed-rate share to 60 per cent, indicating net annual cost savings could reach up to \$500 million, on average, when the 60-per-cent debt structure is in place. Compared to a two-thirds debt structure, the lower fixed-rate structure will modestly increase the Government's short-term exposure to adverse movements in interest rates. However, the analysis also confirms that, over time, the additional costs of an interest rate shock would be more than offset by the savings associated with a lower fixed-rate structure.

Maintaining A Well-Functioning Market

As the sovereign and the largest borrower in the Canadian fixed-income marketplace, the Government has a major interest in sustaining a liquid and efficient market for Government of Canada securities for the purpose of providing stable low-cost funding. A liquid and efficient government securities market also provides key pricing and hedging tools for market participants, thereby contributing to the effective functioning of the broader fixed-income market.

One of the key challenges for the Government in recent years has been to maintain a liquid, well-functioning Government securities market in the face of declining borrowing requirements and reduced issuance. The Government has taken steps to adjust its bond program to maintain participation at auctions and liquidity in the secondary market, principally by concentrating issuance of large benchmark sizes in four key maturity sectors (2, 5, 10 and 30 years) and by introducing a bond buyback program.

The bond buyback program has played a key role in smoothing the transition from the larger bond programs of the 1990s to the smaller programs expected in the future. Gross bond issuance of the Government of Canada peaked at \$54 billion in 1996–97; the 2004–05 program is expected to be slightly less than \$36 billion. A further reduction in bond issuance to around \$33 billion is planned in 2005–06 and, based on continued balanced budgets, annual gross bond issuance is expected to stabilize in the range of \$30 billion to \$35 billion once the 60-per-cent fixed-rate target has been reached in 2007–08. (Detailed information on the 2005–06 programs is contained in the following section, entitled “2005–2006 Debt Strategy: Program Details.”)

In 2005–06 the Government will begin to reduce the size of the buyback program for two principal reasons. First, while the bond buyback program is needed to continue to support a portion of gross bond issuance over the next few years, the requirement for a transition mechanism to smaller sustainable bond programs is diminishing. Second, a reduction in the size of the buyback program is appropriate as the bond stock becomes concentrated in fewer old benchmark bonds which provide liquidity for market participants. The buyback program was initially designed to repurchase less liquid bonds to support new issuance of large, liquid benchmark bonds as the size of the gross bond program was reduced from its peak of \$54 billion in 1996–97 to sustainable programs in the range of \$30 billion to \$35 billion. As the program has matured, many of these less liquid bonds have now been repurchased. As a result, the buyback program now relies on purchasing previously issued liquid benchmark bonds, and “recycles” this liquidity into new benchmark issues (i.e. the extent to which the buyback program contributes to the overall liquidity of the Government of Canada bond market has diminished). In the interest of maintaining a yield curve with a reasonable number of liquid issues, the Government will begin to reduce the buyback program.

Looking forward, annual bond issuance of \$30 billion to \$35 billion is expected to put into question the viability of the current bond program structure—i.e. quarterly auctions of 2-, 5- and 10-year bonds; semi-annual auctions of 30-year bonds; the present benchmark target sizes; and time periods for building benchmark bonds. In the relatively near future, the Government may need to adjust the scope of the bond program to enable maintenance of a well-functioning market for Government of Canada securities in an environment of smaller bond programs.

Accordingly, in 2005–06, the Government plans to assess potential structural changes to the bond program and to consult with market participants on this topic. (Consultations on this issue were initiated in 2004–05.) In the interim, the Government plans to accommodate a reduction in bond issuance in 2005–06 by foregoing the fungible 2-year auction in the fourth quarter of the fiscal year.

Review of the Debt Distribution Framework

In the fall of 2004, the Government initiated a review of its debt distribution framework to ensure that it has continued access to stable, low-cost funding sources over a medium-term horizon and that the Government of Canada securities market continues to function well. The framework, which includes the auction rules and surveillance of participants in the market for Government of Canada securities, was last reviewed in 1998. At that time, measures were put in place to enhance the reliability of access to funding for the Government and to ensure that the auction process would not result in undue concentration of securities or unfair competitive advantage for any particular market participants.

Since the framework was last changed, the Government has conducted auctions that have been consistently covered and well bid. However, participation has become increasingly concentrated, with the Government relying on fewer, large dealers to cover the sale of securities at auctions. The secondary market for Government securities, along with other sectors of the domestic fixed-income market, has also become increasingly concentrated. Other trends that have developed since the last review include an evolution of debt management practices of other governments, interest in direct participation at auctions by institutional and retail investors, greater price transparency and the advent of electronic trading systems.

Consultation meetings were held with market participants and other interested parties in October and November 2004 to help ascertain the current and future effectiveness of the framework and whether changes to the present distribution framework for Government of Canada securities are warranted. To allow for comments from a broad range of parties, a consultation document entitled *Review of the Government of Canada Debt Distribution Framework*¹ was released on the Bank of Canada's Web site. A summary of the comments received is available on the Bank of Canada's Web site at www.bankofcanada.ca.

The review is ongoing and is expected to be completed in 2005–06. The Government is currently assessing the feedback received during the consultations and conducting analysis of the framework. A report on the review, which may identify refinements to the distribution framework, is planned to be published later in 2005–06.

¹ See www.bankofcanada.ca/en/notices_fmd/2004/not181004_preface.

2005–2006 Debt Strategy: Program Details

Domestic Debt Programs

Modifications to debt programs in 2005–06 will continue the orderly adjustment towards the new debt structure target. In this context, the Government will focus on the maintenance of a well-functioning market over the medium-term horizon.

On April 1, 2004, the Government reduced the turnaround time for auctions and buyback operations from a fixed time to a “best efforts basis” (i.e. when ready). There has been a dramatic reduction in turnaround times, with an average for auctions of less than 3 minutes (compared to a maximum of 10 minutes) and for buyback operations of less than 7 minutes (compared to a maximum of 15 minutes).² Lower turnaround time has reduced the market risk for market participants, further enhancing the efficiency of the auction and buyback process. Market participants have strongly supported this change in turnaround time. The Government will continue to reduce turnaround times in 2005–06.

Fixed-Coupon Marketable Bond Program

Gross bond program issuance in 2005–06 is planned to be about \$33 billion, \$3 billion less than in 2004–05. Net marketable bond issuance (net of buybacks) of about \$23 billion will be around \$1 billion lower than in 2004–05. Taking into account bond maturities and cash management bond buyback operations during the year, the stock of bonds is expected to decline from an estimated \$243 billion to about \$235 billion.³

In 2005–06 the Government will continue to hold quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds. However, the Government intends, absent any significant change in its fiscal outlook, to forego the auction of a fungible 2-year bond in the fourth quarter of the 2005–06 fiscal year. This measure taking place in 2005–06 is intended to facilitate a reduction in gross bond issuance in the coming year pending the larger-scale review of the bond program in the fiscal year. The 2-year auction in the third quarter of 2005–06 will be fungible (i.e. shares a common maturity date) with a large existing benchmark bond and will ensure that there is adequate liquidity in the 2-year sector of the curve for market participants. As in previous years, a quarterly calendar of auctions will be posted on the Bank of Canada Web site before the start of each quarter.

The 2-, 5-, 10- and 30-year new maturity benchmark target sizes will remain unchanged from last year (2-year bonds: \$7 billion to \$10 billion, 5-year bonds: \$9 billion to \$12 billion, 10-year bonds: \$10 billion to \$14 billion, and 30-year bonds: \$12 billion to \$15 billion). The benchmark sizes will be achieved through reopenings (where a particular bond issue is sold at several auctions) and switch buyback operations until the benchmark target size is reached.

² For the period from April 1, 2004 to January 26, 2005.

³ Regular bond buybacks do not affect the stock of bonds, as the program supports the issuance of new benchmark bonds.

A list of outstanding Government of Canada bonds, including their maturity dates, is contained in the 2003–04 *Debt Management Report*, which is available on the Department of Finance Web site at www.fin.gc.ca. The list will also be available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be posted on the Bank of Canada's Web site at www.bankofcanada.ca. Starting April 1, the Bank of Canada will update, on a monthly basis, the information on the outstanding amount of Treasury bills and marketable bonds on its Web site.

Bond Buyback Program

The Government conducts two types of bond buyback operations: regular bond buybacks and cash management bond buybacks. Regular bond buybacks permit the maintenance of a liquid new bond issue program by buying existing bonds with a remaining term to maturity from 18 months to 25 years. These buyback operations are sizeable and play a strategic role in maintaining an active new-issue bond program. The second kind of buyback operation, cash management bond buybacks, aids in the management of the Government's cash balances by repurchasing bonds maturing within the next 18 months.

Regular Bond Buyback Operations

Bond buyback operations⁴ can be conducted on a cash or switch basis. Bond buyback operations on a cash basis involve the exchange of less liquid bonds for cash and are conducted shortly after auctions of similar maturity bonds. Bond buyback operations on a switch basis involve the exchange of less liquid bonds for new issue bonds on a duration-neutral basis and are conducted at other times in each quarter.

As noted earlier, in 2005–06 the Government will begin to reduce the buyback program in keeping with its reduced need as a transition mechanism. The Government plans to conduct between \$9 billion and \$10 billion in bond buyback operations in 2005–06, roughly \$1.5 billion less than in 2004–05.

To help support participation by market participants, and reflecting feedback from market consultations, the time between bond auctions and cash buybacks will be reduced from the present 30 minutes to 20 minutes beginning April 1, 2005. Also, the timing of the bond auctions will be advanced from 12:30 p.m. to 12:00 p.m. to allow these auctions and buyback operations to take place earlier in the day. The quarterly maximum repurchase target amounts for the regular bond buyback program and the date of each operation will be announced through the quarterly bond auction calendar published by the Bank of Canada at www.bankofcanada.ca.

⁴ A document entitled *Details on Bond Buyback Operations* relating to the repurchase operations of Government of Canada marketable bonds is available on the Bank of Canada's Web site at www.bankofcanada.ca. It is a compilation of the initiatives previously announced in the Debt Management Strategy documents and other operational enhancements announced on the Bank's Web site over the years.

Cash Management Bond Buybacks (CMBBs)

The CMBB program helps manage the Government's cash requirements by reducing the high levels of cash balances needed ahead of large bond maturities. No major change is planned to CMBB operations in 2005–06.

Real Return Bonds (RRBs)

As a result of the review of the RRB program in 2003–04, the Government affirmed its commitment to the program in the 2004–05 *Debt Management Strategy*. Despite the constraints facing nominal bond issuance over the medium term, the Government will maintain RRB issuance in 2005–06 at a level similar to the \$1.4 billion issued in 2004–05.

Treasury Bill Program

Based on the budget outlook and plans for attaining the 60-per-cent target for the fixed-rate portion of the debt, the stock of Treasury bills is expected to increase by around \$10 billion to about \$140 billion by the end of 2005–06.

Cash management bills (i.e. short-dated Treasury bills) help the Government manage its cash requirements in an efficient manner. The Government intends to continue to actively use cash management bills in 2005–06. In September 2004, the Government announced that minimum bidding requirements and maximum bidding limits would be suspended on a trial basis for a period of at least 12 months for auctions of cash management bills that are non-fungible (i.e. do not share a common maturity date) with a previously issued Treasury bill. The change, which allows participants that have either a limited or strong interest in non-fungible cash management bills to participate to the extent of their interest, has been well accepted by market participants. The trial period will continue in 2005–06.

Domestic Market Development

The Government has been actively involved in supporting the development of enhanced transparency in the Canadian fixed-income market for many years. Greater transparency (i.e. dissemination of trading information regarding prices of securities and volumes traded) for both institutional and retail investors is an important contributor to the development and maintenance of well-functioning and efficient capital markets. The experience of other countries suggests a growing global trend towards higher levels of fixed-income market transparency.

In Canada, positive developments in recent years have enabled progress towards greater transparency. These include the launch of several electronic or alternative trading systems on which fixed-income securities can be traded directly between counterparties, and the establishment of the regulatory framework for these systems. Developments in Canada and abroad suggest that, while maintaining liquidity remains an important objective, a higher level of transparency could be supported for Government of Canada securities.

The Government will be actively working with market participants and securities regulators in 2005–06 to enhance the transparency of Government of Canada securities for both institutional and retail investors.

Retail Debt Program

In September 2004 the Government published an external evaluation of the Retail Debt Program and announced that the program, commonly known as the Canada Savings Bonds Program, would be maintained. The Government also announced that options are being assessed that align the program with the evolving needs of the Government and Canadians. The internal review is ongoing.

Management of the Government's Cash Balances

The Government of Canada manages its cash balances to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. The cash balances are invested through auctions twice daily.

The bulk of the cash balances are invested through a morning auction. The morning auction incorporates a credit management system, using credit ratings, credit lines and collateral arrangements to manage credit risk, and a broad list of eligible counterparties to encourage more competitive bidding at the auctions.

The afternoon auction is used to invest the Government's residual cash balances. This auction is uncollateralized and is limited to Large Value Transfer System participants.

No major change is planned to the cash management framework in 2005–06.

Foreign Reserves

The Government holds foreign exchange reserve assets in the Exchange Fund Account (EFA) to provide foreign currency liquidity and to provide the funds needed to help promote orderly conditions for the Canadian dollar in the foreign exchange markets. Further details on the management of international reserves are available in the *Report on the Management of Canada's Official International Reserves*, which is available on the Department of Finance Web site at www.fin.gc.ca.

The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed on a portfolio basis, based on many of the same principles used by other sovereigns and private sector financial institutions, including prudent risk management principles.

As announced in the budget, the prudent and cost-effective management of the Government's foreign reserves portfolio will be enhanced by the modernization of the Currency Act. Currently, the Act sets out a legislated list of approved investments, which is no longer in keeping with modern legislative drafting practices. Such a list is inflexible and excludes instruments that are equivalent to or better in terms of risk and return than some currently eligible assets.

Modernizing the Act will improve the flexibility in managing the portfolio by allowing investment in asset classes with lower risk and potentially higher returns. It will also reduce the risk of legal issues arising from antiquated and unclear drafting of some sections of the current legislation.

Ongoing management of the EFA is governed by a strict investment policy designed to achieve the risk/return objectives of the Government. Investment activity follows comprehensive credit guidelines that restrict reserves holdings to high-quality, low-risk assets. The investment policy and guidelines are published in the annual *Report on the Management of Canada's Official International Reserves*. Under a revised legislative framework, a ministerial decision to change investment policy would be reported to Parliament and made public through the annual report.

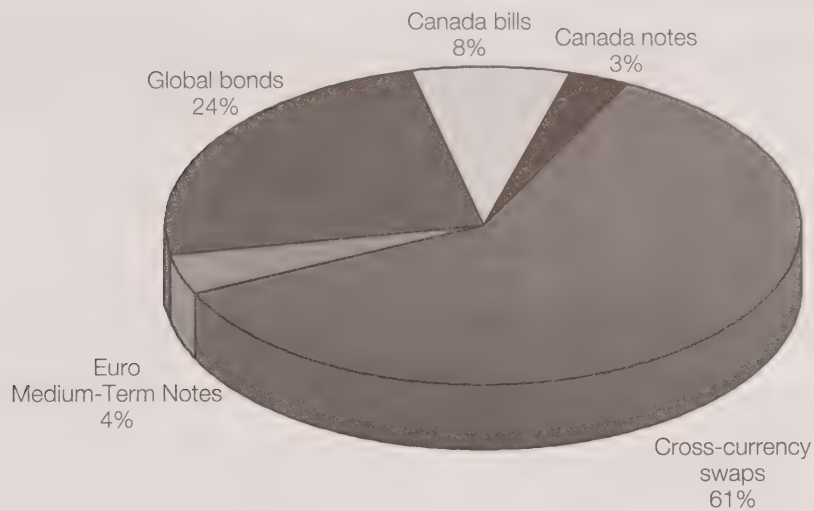
Proposed amendments to the Currency Act to make changes to the eligible investments in the EFA will be introduced shortly.

Funding Sources

The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar paper program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps have proven to be a particularly cost-effective alternative and have been actively used in recent years.

In 2005–06 the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations will continue to be the primary source of reserve funding. Chart 2 shows the expected composition of foreign currency liabilities at March 31, 2005.

Chart 2
Forecast Composition of Foreign Currency Liabilities
March 31, 2005



Source: Department of Finance.

Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing treasury risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. Standards for risk control are high, market risks are immunized, and high standards of credit quality and portfolio diversification are followed.

The Government's risk management policies call for prudent management of treasury risks based on best practices. In recent years the Government has continued to further strengthen its risk management framework by implementing collateral management frameworks for its Receiver General morning auctions, cross-currency swap program, and US-dollar deposit program. Collateral management systems are increasingly the norm in capital markets as a way of managing risk. Under the frameworks, high-quality collateral (e.g. cash, securities) is posted to the Government when its credit exposure to financial institution counterparties exceeds specified limits.

Summary of 2005–2006 Debt Strategy Plan and Intended Results

Debt Structure

Objective: *Gradually reduce the fixed-rate share of debt from two-thirds to 60 per cent by 2007–08.*

Action for 2005–06:

- Continue to reduce the fixed-rate share of debt towards the 60-per-cent target.
- Increase the size of the Treasury bill program from about \$130 billion in 2004–05 to approximately \$140 billion in 2005–06.
- Issue about \$33 billion of bonds in 2005–06, about \$3 billion less than in 2004–05. Due to large bond maturities and continued bond buyback operations, the bond stock is expected to decrease by some \$8 billion.
- Reduce the size of the buyback program, with a planned level of between \$9 billion and \$10 billion, roughly \$1.5 billion less than in 2004–05.
- Maintain a stable maturity profile.

Intended Result:

- ➔ Achieve lower debt charges, while continuing to prudently mitigate the risk to the budget framework.
- ➔ Facilitate market adjustment to changes in the bond and Treasury bill programs.
- ➔ Prepare for the end of the transition to sustainable bond programs and preserve liquidity in outstanding issues.
- ➔ Limit the need to refinance a large portion of debt in any given period.

Domestic Debt Programs

Objective: *Maintain diversified sources of funding and a well-functioning market.*

Action for 2005–06:

- Continue regular issues of marketable bonds in four maturity sectors, Treasury bills in three maturity sectors and a long-dated inflation-linked bond.
- Continue to borrow on a pre-announced basis and provide timely notices of government policy decisions.
- Maintain current new maturity benchmark target sizes for 2-, 5-, 10- and 30-year bonds.
- Forego the 2-year auction in the fourth quarter of 2005–06.
- Consult with market participants in 2005–06 on potential changes to the structure of the bond program.
- Advance the timing of bond auctions from 12:30 p.m. to 12:00 p.m.
- Advance the timing of cash buybacks from 1:00 p.m. to 12:20 p.m., 10 minutes closer to the bond auction than previously.
- Continue to work to lower turnaround times for the release of results of auctions and buybacks.
- Update the retail debt strategy.

Intended Result:

- ➔ Keep costs low and mitigate funding risk by diversifying borrowing across investor segments, instruments and maturities.
- ➔ Maintain transparency and efficiency.
- ➔ Maintain a liquid market for on-the-run issues and building-benchmark issues.
- ➔ Facilitate a reduction in bond issuance in 2005–06 pending a review of the bond program structure.
- ➔ Adjust the structure of the bond program to achieve the structural target while maintaining a well-functioning government securities market.
- ➔ Encourage participation by reducing market risk for participants.
- ➔ Enhance the bidding process and participation.
- ➔ Ensure the evolving needs of the Government and Canadians are met.

Foreign Reserves

Objective: *Improve the cost-effectiveness of funding foreign reserve assets.*

Action for 2005–06:

- Modernize the Currency Act, which provides the legislative basis for the management of the foreign reserves.
- Continue to review the foreign reserves portfolio investment policy.
- Continue to use cross-currency swaps as the primary source of reserves funding.

Intended Result:

- ➔ Reduce potential for legal risk issues by modernizing the Act, and increase flexibility of investment policy.
- ➔ Improve the risk/return profile of the portfolio, with the possible inclusion of new asset classes.
- ➔ Keep the cost of carrying reserve assets low.

Glossary

accumulated deficit: Total liabilities less financial and non-financial assets.

asset liability management: A systemic investment decision-making framework that is used to concurrently manage a portfolio of assets and liabilities.

basis point: One-hundredth of a percentage point (0.01 per cent).

benchmark bond: The specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenses. A deficit is the shortfall between government revenues and budgetary expenses.

buyback on a cash basis: The repurchase of bonds for cash. Used to maintain the size of auctions and new issuance.

buyback on a switch basis: The exchange of outstanding bonds for new bonds in the current building benchmark.

Canada bill: A promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserve funding purposes only.

Canada note: A promissory note usually denominated in US dollars and available in book-entry form. Canada notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserve funding purposes only.

Canada Premium Bond: A non-marketable security instrument issued by the Government of Canada that is redeemable once a year on the anniversary date or during the 30 days thereafter without penalty.

Canada Savings Bond: A non-marketable security instrument issued by the Government of Canada that is redeemable on demand by the registered owner(s) and that, after the first three months, pays interest up to the end of the month prior to cashing.

Contingency Reserve: Is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts and risks arising from unpredictable events. If not needed, it is used to pay down the public debt.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

electronic trading system: An electronic system that provides real-time information about securities and enables the user to execute financial trades.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar in the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

financial requirement/source: Measures the difference between cash coming in to the Government and cash going out. In the case of a financial requirement, if cash on hand is not used, it is the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-coupon marketable bond: A market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fungible bond: A bond that has the same financial attributes as another. Fungible bonds are interchangeable.

government securities distributor: A member of a group of investment banks and dealers through which the Government distributes Government of Canada Treasury bills and marketable bonds.

gross public debt: The total amount the Government owes. It consists of market debt in the form of outstanding securities such as Treasury bills, marketable bonds and Canada Savings Bonds, non-market debt owed mainly to the superannuation accounts for government employees, and other current liabilities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

market debt: For debt management purposes, market debt is defined as the portion of debt that is funded in the public markets, and consists of marketable bonds, Treasury bills, retail debt (primarily Canada Savings Bonds), foreign currency denominated bonds and bills, and bonds issued to the Canada Pension Plan.

marketable debt: Market debt that is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

net debt: Gross debt, net of financial assets.

non-market debt: Consists of the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest payments and payments of matured debt).

non-marketable debt: Market debt that is not tradable and that is issued to retail investors (Canada Savings Bonds and Canada Premium Bonds).

primary market: The market in which securities are initially sold or offered.

real return bond (RRB): Government of Canada RRBs pay semi-annual interest based upon a real interest rate. Unlike standard fixed-coupon marketable bonds, interest payments on RRBs are adjusted for changes in the Consumer Price Index.

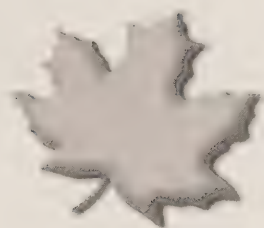
secondary market: The market in which previously issued securities are traded, as distinguished from the new issue or primary market.

sovereign market: The market for the debt issued by a government.

Treasury bill: A short-term obligation sold by public tender. Treasury bills with terms to maturity of 3, 6 or 12 months are currently auctioned on a biweekly basis.

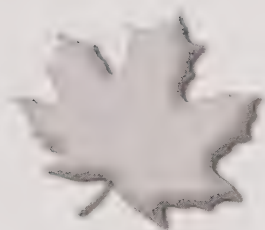
turnover ratio: The volume of securities traded as a percentage of total securities outstanding.

yield curve: A graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.



DEBT MANAGEMENT STRATEGY

2006–2007



DEBT MANAGEMENT STRATEGY

2006–2007



Department of Finance
Canada

Ministère des Finances
Canada



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Foreword by the Minister of Finance

I am pleased to table before Parliament the Government of Canada's *Debt Management Strategy* for fiscal year 2006–07. This document provides comprehensive information on the Government's debt strategy and objectives for the coming fiscal year.

The debt strategy is an important component of the fiscal planning of the Government of Canada. The strategy is focused on ensuring a low and stable cost of servicing the federal debt. It also contributes to a well-functioning Government of Canada securities market for the benefit of a wide array of borrowers and investors.

The strategy is developed against the background of declining federal debt. Combined with forecast economic growth, the federal debt-to-GDP (gross domestic product) ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt as a percentage of the economy is projected to fall to 35 per cent in 2006–07, down from its peak of 68.4 per cent in 1995–96. Canada's total government debt burden is the lowest in the Group of Seven (G7). The Government is committed to further paying down the federal debt.

The debt strategy incorporates the results of consultations with market participants on the development and implementation of policy, consistent with a commitment to openness and transparency. The publication of this document, together with the separate publication during the year of the *Debt Management Report* and the *Report on the Management of Canada's Official International Reserves*, contributes to the accountability of the Government to Parliament and to Canadians on the Government's financial strategy and transactions.

The Honourable James M. Flaherty, P.C., MP
Minister of Finance
April 2006

Purpose of This Publication

The *Debt Management Strategy* is an annual publication of the Department of Finance Canada. It sets out the Government of Canada's objectives and strategies for managing its debt and related financial assets over fiscal year 2006–07.

The Government publishes companion documents, the *Debt Management Report* and the *Report on the Management of Canada's Official International Reserves*, which describe the Government's financial market operations in respect of the debt and reserves, respectively, after the fiscal year has ended.

Focus of the Federal Debt Strategy

The debt strategy focuses on the management of the market debt and associated derivatives transactions of the Government of Canada. The debt strategy also reflects and encompasses in its framework the management of the Government's financial assets.

(At March 31, 2005) (C\$ billions)

Market Debt

<i>Payable in Canadian currency</i>	
Marketable bonds	266.6
(fixed-coupon bonds with 2-, 5-, 10- and 30-year maturities and Real Return Bonds with 30-year maturities)	
Treasury bills	127.2
(zero-coupon securities with 3-, 6- and 12-month maturities)	
Retail debt	19.1
(Canada Savings Bonds and Canada Premium Bonds)	
Canada Pension Plan bonds	3.4
Obligations related to capital leases	2.9
 <i>Payable in foreign currency</i>	
Marketable bonds	12.4
(fixed-coupon bonds, Canada notes and Euro Medium-Term Notes)	
Canada bills	3.9
(zero-coupon securities with 1- to 9-month maturities)	
	<hr/> 435.5

Derivatives Portfolio

Cross-currency swaps	24.5
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Liquid Financial Assets

Cash	20.6
Foreign exchange reserves	38.9
	<hr/> 59.5

Source: *Public Accounts of Canada*.

Highlights of the 2006–2007 Debt Strategy

Debt Structure and Issuance Plan

- To lower public debt costs, the fixed-rate share of the debt will continue to be reduced from two-thirds in 2002–03 to a target of 60 per cent in 2007–08. The change is being made gradually to facilitate market adjustment. Specifically:
 - The outstanding amount of treasury bills will increase from about \$131 billion at the end of 2005–06 to a range of \$135 billion to \$140 billion by the end of 2006–07.
 - The total amount of marketable bonds issued in 2006–07 will be about \$31 billion, \$1 billion less than planned for 2005–06. Marketable bond issuance (net of buybacks) of about \$23 billion will also be about \$1 billion less than in 2005–06.
 - In 2005–06, the Government began to reduce the size of the bond buyback program. This reduction will continue in 2006–07, with a planned amount of bond buybacks in the order of \$7 billion to \$8 billion, about \$1 billion less than in 2005–06.
 - The stock of marketable domestic bonds is expected to decline from an estimated \$237 billion at the end of 2005–06 to about \$231 billion as a result of maturities and continued cash management buyback operations.

Bond Program Design Changes

- To accommodate the shift to a lower fixed-rate debt structure, the following changes to the bond program's design, developed in consultation with market participants, will be made:
 - The dating of the 5-year benchmark maturity will be changed from September 1 to June 1 to make new 5-year benchmarks fungible with old 10-year benchmarks. The 5-year auction in the fourth quarter will be dropped from the issuance plan.
 - The issuance of 2- and 5-year bonds will be reduced to take advantage of their fungibility with outstanding benchmarks. As in 2005–06, the Government will not conduct a 2-year bond auction in the fourth quarter of the fiscal year.

Operational Enhancements

- The floor for the repurchase of bonds will be reduced from \$6 billion to \$5 billion in all maturities to increase the amount of bonds eligible for purchase at buyback operations.
- To enhance bidding and participation in domestic debt operations, the Bank of Canada will target average turnaround times (the time from the bidding deadline to the release of auction results and settlement details) of less than 3 minutes for auctions and less than 5 minutes for buybacks. The maximum turnaround times will be reduced from 10 minutes to 5 minutes for auctions and from 15 minutes to 10 minutes for buyback operations.

Policy Initiatives

- The merits of consolidating some or all of the borrowing by major government-backed entities into government debt programs will be assessed, following up on an evaluation done by KPMG LLP in 2005–06 (see www.fin.gc.ca/toce/2005/MFGBE-e.html).
- Research and consultations with market participants and regulators will continue on the transparency of the market for Government of Canada securities.

Funds Management Framework

Funds management is the general term used to describe the wide range of activities related to the management of the debt and liquid financial assets of the federal government. The framework has a number of elements, as explained in the following sections.

Authority and Governance

Debt and Cash Management

The authority for funds management flows from Part IV of the Financial Administration Act (FAA), which empowers the Minister of Finance to borrow money on behalf of Her Majesty in right of Canada. In this regard, the Minister is authorized to issue securities and do any other thing related to the borrowing of money that the Minister considers appropriate. The FAA also states that the Governor in Council may authorize the Minister to enter into any contract or agreement of a financial nature, including cash management arrangements and derivatives transactions, on such terms and conditions as the Minister considers necessary.

Under the FAA the Government has standing authority to refinance market debt maturing in a fiscal year. Parliamentary approval must be obtained to raise new market debt, in the form of a borrowing authority bill. Once obtained, the authority to raise debt levels generally extends through the remainder of the fiscal year and lapses at the start of the next fiscal year. Section 49 of the FAA requires the Minister to table in every fiscal year, in each House of Parliament, a report on the Minister's plans in relation to the management of the public debt in the next fiscal year. This report fulfills that obligation.

Foreign Reserves Management

Canada's official international reserves are held in the Exchange Fund Account (EFA). Authority for the management of the foreign reserves is provided by Part II of the Currency Act. The legislative mandate of the EFA is to aid in the control and protection of the external value of the Canadian dollar. The Minister of Finance can acquire, sell, borrow or lend for the Account those assets that are deemed appropriate for the legislated purpose. The Minister of Finance approves the general policies and strategy related to the investment and risk management of the EFA and establishes the target level of reserves.

Institutional Responsibilities

Responsibility for strategic planning and the operational management of the Government's debt and financial assets is delegated to officials at the Department of Finance Canada and the Bank of Canada. The Bank of Canada acts as fiscal agent for the Minister of Finance in issuing debt and conducting other debt market operations.

Oversight of policy and operations activity is carried out through a Funds Management Committee (FMC), which comprises senior management from the Department of Finance Canada and the Bank of Canada. The FMC advises the Minister of Finance on policy and strategy, oversees the implementation of approved policy and plans, and reviews performance outcomes.

For more information on the funds management framework, see www.fin.gc.ca/treas/Goveev/TMGF_e.html.

Principles and Objectives

Domestic debt and cash management, and foreign reserves management, have distinct objectives and principles. All funds management activities are conducted in keeping with overarching principles (see box on next page).

Domestic Debt and Cash Management

Objective

The fundamental objective of domestic debt and cash management is to raise stable and low-cost funding to meet the operational needs of the Government of Canada.

An associated objective is to maintain a well-functioning market in Government of Canada securities, which helps to keep debt costs low and benefits a wide array of domestic market participants.

Principles

Transparency, Regularity and Liquidity

The design and implementation of the domestic debt program should emphasize transparency, regularity and liquidity to support a well-functioning government securities market. The Government should consult regularly with market participants to ensure the integrity and attractiveness of the market for dealers and investors.

Prudence

Prudence should be maintained by managing the structure of the debt, raising funds for domestic operational needs using a variety of instruments denominated in Canadian dollars, and managing exposure to credit risk through diversification.

Foreign Reserves Management

Objective

The objective of foreign reserves management is to provide general foreign currency liquidity for the Government and to provide a source of funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market.

Principles

Prudence

The foreign reserves should be managed to limit exposure to financial risk through the matching of assets and liabilities, prudent investment limits and diversification in instruments and currencies held.

Cost-Effectiveness

The reserves investment portfolio should be actively managed such that the net cost to the taxpayer, if any, is minimized.

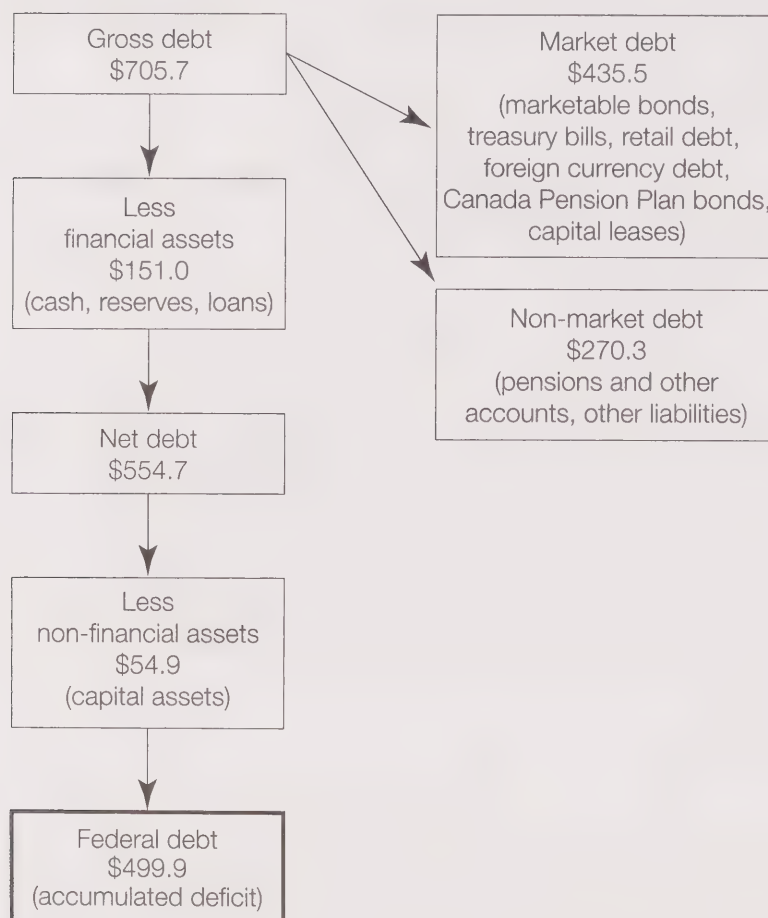
Overarching Funds Management Principles

- Risk management: Debt and asset management activities should be conducted in line with clear operational and risk guidelines, and risk monitoring and oversight should be independent of treasury management operations.
- Efficiency and effectiveness: Policy and operational standards should take into account, to the extent possible, the leading practices of other comparable sovereigns. Regular evaluations should be conducted to ensure the efficiency and effectiveness of the governance framework, policy initiatives and operations.
- Reporting: Information on funds management plans, activities and outcomes should be made publicly available in a timely manner so as to ensure understanding and accountability.

Debt and Assets Managed

The debt strategy plan focuses on the Government of Canada's market debt, which is the largest component of its gross debt. The other component of the gross debt, non-market debt, which includes federal public sector pension liabilities and the Government's accrued liabilities, is not subject to active management. Figure 1 illustrates the relationships between the components of the federal debt at March 31, 2005.

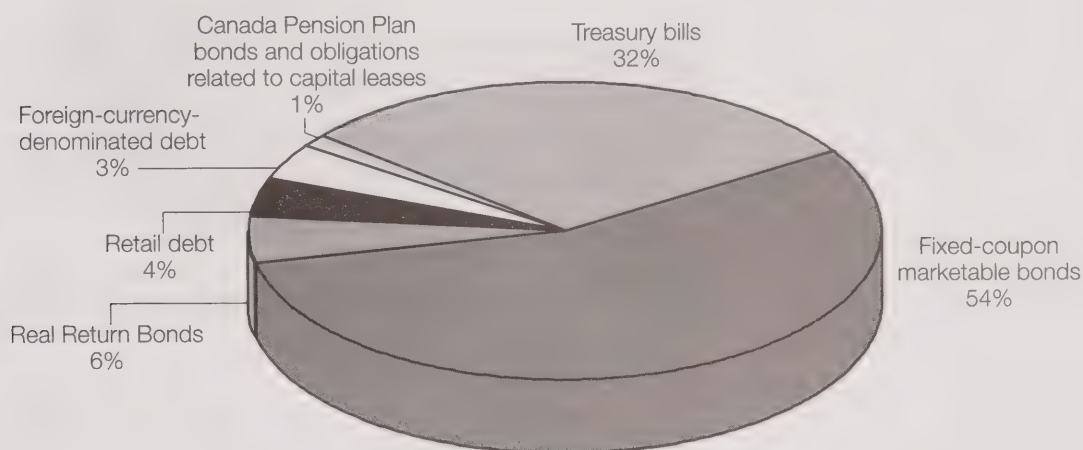
Figure 1
Federal Debt at March 31, 2005
 (in billions of dollars)



Note: Numbers may not add due to rounding.
 Source: *Public Accounts of Canada*.

The Government's market debt is the portion of the federal debt borrowed in financial markets and consists primarily of fixed-coupon marketable bonds (2-, 5-, 10- and 30-year), Real Return Bonds (30-year), treasury bills (3-, 6- and 12-month), retail debt (Canada Savings Bonds and Canada Premium Bonds) and foreign-currency-denominated debt. It also includes bonds issued to the Canada Pension Plan and obligations related to capital leases, although these are not borrowed from the market or actively managed. The shares of each of these components are shown in Chart 1.

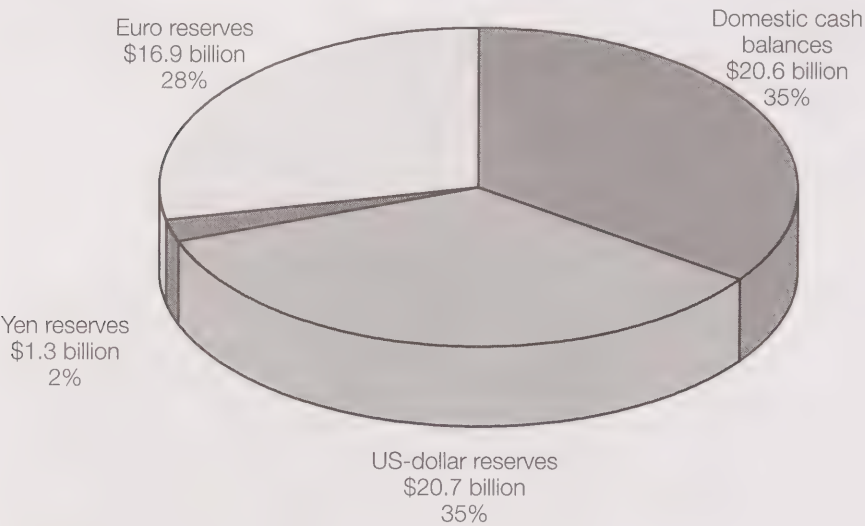
Chart 1
Composition of Market Debt
March 31, 2005



Source: Department of Finance Canada.

The debt strategy plan also addresses the management of the Government’s liquid financial assets, which include cash balances (invested with banks for very short terms) and the liquid foreign exchange reserves (as portfolios of deposits and securities). The composition of these assets is shown in Chart 2.

Chart 2
Liquid Cash and Reserves
March 31, 2005



Source: Department of Finance Canada.

Fiscal Policy

The Government's fiscal policy, as set out in the budget, sets the context and operational objectives for debt management operations. The Government has recorded budgetary surpluses over the past eight fiscal years and has reduced the federal debt by \$63 billion.

Combined with forecast economic growth, the federal debt-to-GDP ratio—the level of debt in relation to the country's annual income—remains on a downward track. On an accrual basis, the federal debt as a percentage of the economy is projected to fall to 35 per cent in 2006–07, down from its peak of 68.4 per cent in 1995–96.

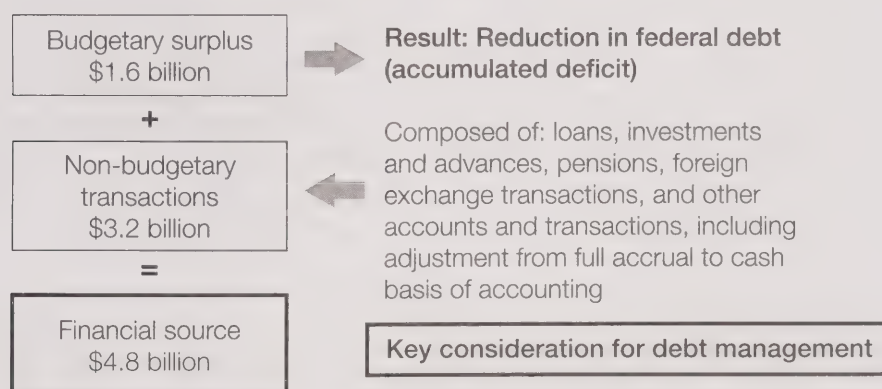
In terms of international debt burden comparisons, taking into consideration the accounting methods of various sovereigns, Canada's total government debt burden is the lowest in the G7.

Financial Requirement/Source

The key budgetary consideration for debt management planning is the financial requirement/source rather than the budgetary balance (see box on following page). The 2006–07 debt strategy plan is based on the assumption of a balanced budget and a near-zero financial requirement/source.

Figure 2 presents the various elements of the Government's budgetary framework for the 2004–05 fiscal year, the last year for which audited Public Accounts financial statements are available.

Figure 2
Financial Source at March 31, 2005



Source: *Public Accounts of Canada*.

Borrowing Authority

Currently available borrowing authority is limited to the standing authority to refinance market debt maturing in a fiscal year, plus a \$4-billion non-lapsing contingency from the 1996–97 Borrowing Authority Act. Financial requirements in 2006–07 are expected to be met without seeking new borrowing authority.

Measuring the Government's Fiscal Position: Budgetary Balance and Financial Requirement/Source

The budgetary balance and financial requirement/source measures used in the *Debt Management Strategy* are based on the Public Accounts accounting framework. The Public Accounts provide information to Parliament on the Government's financial activities, as required under the Financial Administration Act. The measures are provided on a fiscal-year basis ending March 31.

The budgetary balance—deficit or surplus—is one measure of the Government's financial situation. Consistent with the recommendations of the Auditor General of Canada, the Government moved to full accrual accounting in 2002–03. The move enhances transparency and decision making by providing a more complete accounting of government activities than under the previous modified accrual accounting framework. Under the full accrual basis of accounting, revenues and expenses are recorded when they are incurred, regardless of when the actual cash flows occur.

The financial requirement/source provides a measure of the net cash position of the Government. In contrast, the budgetary balance also includes obligations incurred by the Government during the course of the year for which the cash transaction does not take place until future years. In general terms, the difference between the financial requirement/source and the budgetary balance is timing (i.e. when funds for budgetary items are committed and the actual cash transaction occurs).

The financial requirement/source includes the cash outlays related to current- and prior-year budget commitments. It also includes transactions in loans, investments and advances, federal employees' pension accounts, other specified purpose accounts, foreign exchange activities, and changes in other financial assets, liabilities and non-financial assets. These activities are included as part of non-budgetary transactions. The financial requirement/source corresponds closely to the unified budget balance measure used in the United States.

2006–2007 Debt Strategy: Major Themes

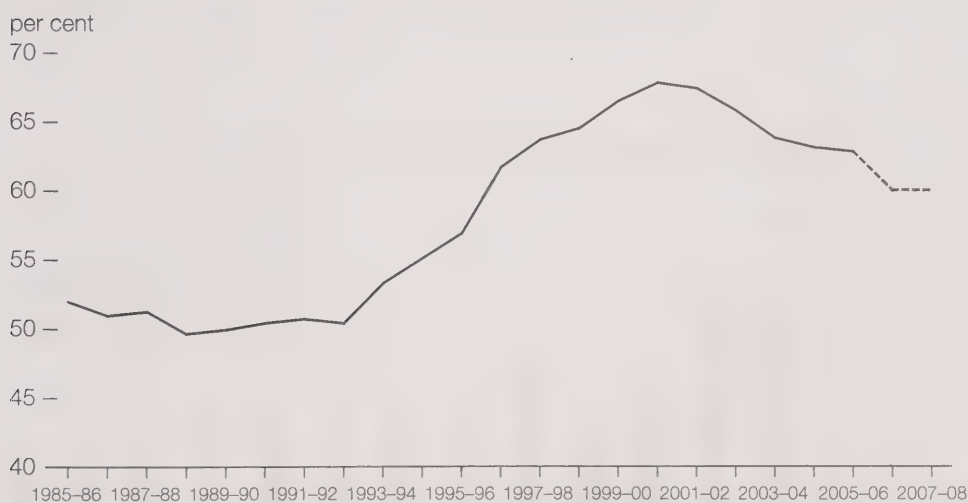
Changing the Debt Structure

The fundamental objective in managing the debt is to strike the appropriate balance between low financing costs and cost stability over a medium-term horizon. The main target in this regard is the fixed-rate share of the debt—that is, the share of the debt that is not maturing or being repriced within a year.

In general, long-term debt is less risky, but more costly, than short-term debt. In an environment of macroeconomic stability and declining debt, the Government has greater capacity to absorb interest rate variability. At the same time, given the level of federal debt, a prudent debt structure is needed to protect the fiscal position from unexpected increases in interest rates and to limit annual refinancing needs.

In 2002–03, the decision was taken to reduce the fixed-rate share of the debt from two-thirds to a target of 60 per cent by 2007–08 (see Chart 3). Given variations in government bond maturities during the year, maintenance of the target on a month-to-month basis will incorporate an operational range of ± 1 per cent. The change is being made gradually to facilitate market adjustment. Updated analysis continues to support the reduction in the fixed-rate share of the debt to 60 per cent, indicating net annual cost savings could reach up to \$500 million, on average, when the 60-per-cent debt structure is in place.

Chart 3
Fixed-Rate Share of the Debt



Sources: Bank of Canada and Department of Finance Canada.

Compared to a two-thirds debt structure, the lower fixed-rate structure modestly increases the Government’s short-term exposure to adverse movements in interest rates. However, the analysis indicates that, over time, the additional costs of an interest rate shock would be more than offset by the savings associated with a lower fixed-rate structure.

In 2006–07, the Government will continue the transition from two-thirds to the 60-per-cent target by 2007–08 by adjusting the issuance levels of treasury bills and bonds. These adjustments are detailed in the section “2006–2007 Debt Strategy: Program Plans.”

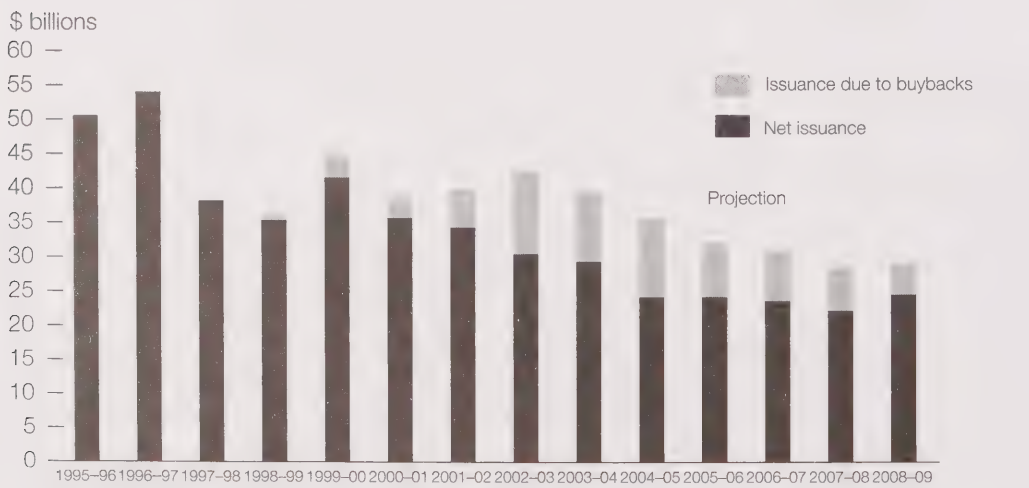
Maintaining A Well-Functioning Bond Market

The Government has a major interest in sustaining a liquid and efficient market for Government of Canada securities. A liquid and efficient government securities market is attractive to investors and thus helps to keep debt costs low. It also provides key pricing and hedging tools for market participants, thereby contributing to the effective functioning of the broader fixed-income market.

One of the key challenges for the Government in recent years has been to maintain a liquid, well-functioning government securities market in the face of declining borrowing requirements and reduced issuance of fixed-rate securities. A key initiative in this regard has been the use of bond buybacks, which have facilitated the maintenance of a higher level of gross bond issuance.

Gross annual bond issuance has declined over the past 10 years, from a peak of \$54 billion in 1996–97 to about \$32 billion in 2005–06. Assuming continued balanced budgets, annual gross bond issuance is planned to stabilize at about \$30 billion once the 60-per-cent fixed-rate target has been reached in 2007–08 (see Chart 4).

Chart 4
Government of Canada Bond Program



Source: Department of Finance Canada.

In view of the outlook, the primary focus of this year's debt strategy is to facilitate a temporarily lower bond issuance for 2006–07 and 2007–08 without making permanent, potentially disruptive changes to the bond program. A key initiative this year is to take greater advantage of fungibility (i.e. the ability to combine different bonds that share the same maturity date) between old outstanding bonds and new benchmark issues. Fungibility will permit key maturities of the current bond program (i.e. 2-, 5-, 10-, and 30-year) to be maintained in the context of smaller total issuance. At the same time, issuance of new 2- and 5-year bonds will be reduced in recognition of large outstanding fungible bonds “rolling down” into those parts of the curve to help support liquidity in all four maturities.

Meanwhile, the size of the buyback program will continue to be reduced based on two considerations. First, while the bond buyback program has helped to support the maintenance of gross bond issuance, the requirement for a transition mechanism to smaller sustainable bond programs is diminishing. Second, a reduction in the size of the buyback program is appropriate as the bond stock becomes concentrated in fewer old benchmark bonds, which remain of value to market participants.

Detailed information on 2006–07 program plans is provided in the following section.

2006–2007 Debt Strategy: Program Plans

Domestic Debt Programs

In November 2005, as in past years, officials from the Department of Finance Canada and the Bank of Canada consulted with interested parties on issues relating to the design and operation of the Government of Canada's debt programs for fiscal year 2006–07 and beyond. This year's consultations addressed a broad spectrum of potential adjustments to the Government's bond program that permit debt structure adjustment while maintaining a well-functioning bond market. A consultation paper (www.bank-banque-canada.ca/en/notices_fmd/2005/not281005_debt.html) set out for comment potential near-term changes that largely preserve the current structure of the bond program as well as more fundamental changes in the design of the bond program over the medium term.

Market participants recognized that the Government faces challenges in maintaining well-functioning markets for Government of Canada securities while continuing to gradually reduce the bond program in a context of lower borrowing needs and moving to a lower fixed-rate share of government debt.

Most participants were of the view that liquidity is adequate along the yield curve, but is sometimes limited at the long end. Market participants indicated that there is a strong demand for Government of Canada securities and noted decreasing supply, especially in the long end, where there is a structural need for bonds and limited substitutes. Liquidity is anticipated to become increasingly under pressure as more investors adopt a buy-and-hold strategy and as demands for collateral become more common.

Market participants strongly supported continuing to take advantage of fungibility in the 2-year sector and changing the 5-year maturity date from September 1 to June 1 to support issuance in other sectors while maintaining adequate liquidity in all four maturities. A majority of market participants were also in favour of a modest reduction of the regular buyback floor below which large off-the-run benchmark bonds are currently not repurchased from \$6 billion to \$5 billion. Participants also supported the concept of using interest rate swaps as a future means of maintaining gross issuance and benchmark sizes.

More details on the views expressed during the consultations can be found at www.bankofcanada.ca/en/notices_fmd/index.html.

Fixed-Coupon Marketable Bond Program

In 2006–07, gross bond program issuance is planned to be about \$31 billion, \$1 billion less than planned for 2005–06. Marketable bond issuance (net of buybacks) of about \$23 billion will be around \$1 billion less than in 2005–06. Taking into account bond maturities and cash management bond buyback operations during the year, the stock of bonds is expected to decline from an estimated \$237 billion to about \$231 billion.

Quarterly auctions of 2-, 5- and 10-year bonds and semi-annual auctions of 30-year bonds will continue, with quarterly auction calendars issued by the Bank of Canada and posted on their website before the start of each quarter. However, one 2-year and one 5-year auction that are fungible with outstanding bonds will be forgone, both in the fourth quarter of the fiscal year. This will allow appropriate auction sizes to be maintained in all bond maturities in the context of smaller overall bond issuance.

Bond Auctions by Quarter,

Fiscal Year 2005–06				Fiscal Year 2006–07			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
2-year	2-year	2-year	–	2-year	2-year	2-year	–
5-year	5-year	5-year	5-year	5-year	5-year	5-year	–
10-year	10-year	10-year	10-year	10-year	10-year	10-year	10-year
–	30-year	–	30-year	–	30-year	–	30-year

Source: Bank of Canada.

The maturity date of new 5-year benchmarks will be changed from September 1 to June 1 starting in October 2006 to make the new 5-year bonds fungible with previous 10-year benchmarks.

Given the fungibility of shorter-term bonds with large outstanding issues, there will be a modest reallocation of issuance volume to 30-year fixed-coupon bonds and 30-year Real Return Bonds to support liquidity at the long end of the curve.

The 2-, 5-, 10- and 30-year benchmark target sizes for new issue bonds, which are not fungible with existing benchmarks, will remain unchanged from last year (2-year bonds: \$7 billion to \$10 billion; 5-year bonds: \$9 billion to \$12 billion; 10-year bonds: \$10 billion to \$14 billion; and 30-year bonds: \$12 billion to \$15 billion).

A list of outstanding Government of Canada bonds, including their maturity dates, is contained in the 2004–05 *Debt Management Report*, which is available on the Department of Finance Canada website at www.fin.gc.ca. The list will also be updated monthly on the Bank of Canada website (www.bankofcanada.ca/en/goc/goc.html) and will be available in the forthcoming annual publication, *Summary of Government of Canada Direct Securities and Loans*, which will be posted on the Bank of Canada's website at www.bankofcanada.ca.

Bond Buyback Programs

Two types of bond buyback operations will continue to be conducted: regular bond buybacks and cash management bond buybacks. Regular bond buybacks permit the maintenance of a liquid new bond issue program by buying existing bonds with a remaining term to maturity from 18 months to 25 years. Cash management bond buybacks aid in the management of cash balances by repurchasing bonds maturing within the next 18 months.

Regular Bond Buyback Operations

Bond buyback operations will continue on both a cash and a switch basis. Bond buyback operations on a cash basis involve the exchange of less liquid bonds for cash and are conducted shortly after auctions of similar maturity bonds. Bond buyback operations on a switch basis involve the exchange of less liquid bonds for new issue bonds on a duration-neutral basis and are conducted at other times in each quarter.

As noted earlier, bond buybacks will be reduced in overall terms, in keeping with their reduced value as a transition mechanism. The target for 2006–07 is to conduct between \$7 billion and \$8 billion in bond buyback operations, about \$1 billion less than in 2005–06. The quarterly maximum repurchase target amounts for the regular bond buyback program and the date of each operation will be announced through the quarterly bond auction calendar published by the Bank of Canada.

For regular buybacks, the existing \$6-billion floor will be reduced to \$5 billion in all maturities to increase the amount of bonds eligible for repurchase at buyback operations.

Cash Management Bond Buybacks (CMBBs)

The CMBB program helps manage the Government's cash requirements by reducing the high levels of cash balances needed ahead of large bond maturities. No major change is planned to CMBB operations in 2006–07.

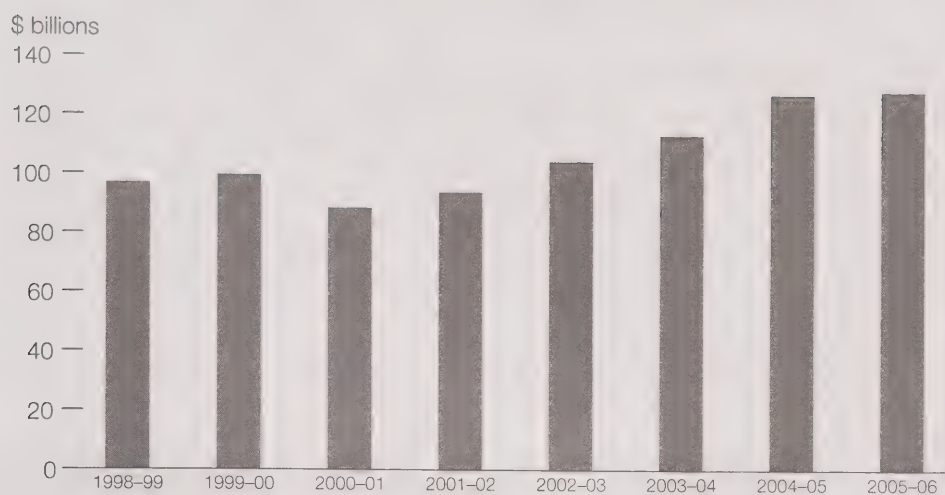
Real Return Bonds (RRBs)

The 2006–07 plan calls for a modest increase in long-term RRB issuance to about \$1.6 billion. The level of RRB issuance is being increased slightly in view of market demand, despite a decline in gross bond issuance.

Treasury Bill Program

Based on plans for attaining the 60-per-cent target for the fixed-rate portion of the debt, the stock of treasury bills is expected to increase by around \$6 billion to a range of \$135 billion to \$140 billion by the end of 2006–07. Markets have adjusted smoothly to the growth in the stock of treasury bills, which has increased from less than \$90 billion at the end of the 2000–01 fiscal year to approximately \$131 billion by the end of fiscal 2005–06 (see Chart 5).

Chart 5
Treasury Bills Outstanding



Source: Department of Finance Canada.

Cash management bills (i.e. short-dated treasury bills) help the Government manage its cash requirements in an efficient manner. The Government intends to continue to actively use cash management bills in 2006-07.

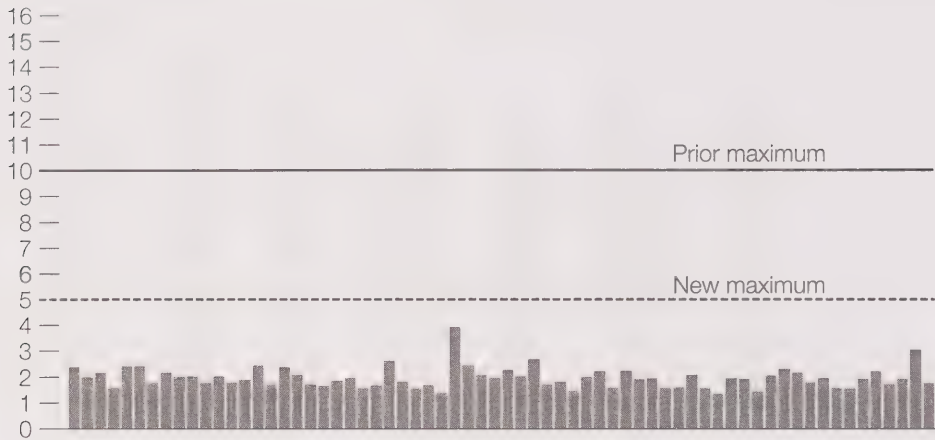
Operational Enhancements

For the past two years, the Bank of Canada's turnaround time for auctions and operations in which bonds are repurchased has been changed from fixed times of 10 and 15 minutes, respectively, to a "best efforts basis" (i.e. as soon as ready). Over this period, turnaround times have averaged less than 3 minutes for auctions and less than 7 minutes for buybacks (see Charts 6 and 7). The reduction in turnaround times has helped reduce market risk for auction participants and has improved the efficiency of the auction process.

In 2006-07, the Bank is committed to keeping average turnaround times under 3 minutes for auctions and under 5 minutes for buybacks, while maximum turnaround times will be reduced from 10 minutes to 5 minutes for auctions, and from 15 minutes to 10 minutes for buyback operations.

Chart 6
Bill and Bond Auction Turnaround Times
April 2005–February 2006

minutes past deadline



Source: Bank of Canada.

Chart 7
Repurchase and Switch Auction Turnaround Times
April 2005–February 2006

minutes past deadline



Source: Bank of Canada.

Policy Reviews

Borrowing Framework Used by Major Government-Backed Entities

The Minister of Finance has statutory responsibility for approving borrowing and debt guarantees issued by a number of Crown corporations and federal government-backed entities. These activities are backed by the full faith and credit of Canada and, as such, are an extension of the treasury management framework of the Government. Given the size and scope of the activities of these borrowers, it is in the public interest that they be managed efficiently within a robust governance and accountability framework.

An external evaluation of the borrowing framework governing borrowing by the Business Development Bank of Canada, Export Development Canada, Farm Credit Canada, the Canadian Wheat Board and Canada Mortgage and Housing Corporation (CMHC), along with the CMHC-guaranteed Canada Housing Trust, was completed by an external evaluator (KPMG LLP) in June 2005 under the auspices of the Department of Finance Canada's treasury evaluation program. KPMG LLP observed that the current governance system is functioning well between the Government of Canada and all of the organizations. However, it advised that consolidating these guaranteed borrowings with the Government of Canada's domestic debt issuance could generate cost savings and enhance the liquidity of the Government of Canada bond market. It noted that there are concerns about the impact of such an approach on the existing borrowers (e.g. impact on client service, loss of market intelligence) and that further work is needed to determine whether these concerns could be addressed through the design of a centralized borrowing regime.

In 2006, the Department of Finance Canada, in conjunction with the borrowers, will be evaluating further the merits of consolidating some or all of federal government-backed borrowings with the Government of Canada debt program.

Transparency of Government Securities Market

Officials of the Department of Finance Canada and the Bank of Canada have been actively supporting the development of enhanced transparency in the Canadian fixed-income market for many years. Transparency (i.e. the dissemination of trading information regarding prices of securities and volumes traded) for both institutional and retail investors is an important contributor to the development and maintenance of well-functioning and efficient capital markets.

In Canada, developments in recent years have enabled the provision of greater transparency to investors. These include the launch of electronic or alternative trading systems (ATSS) on which fixed-income securities can be traded between counterparties and the development of a regulatory framework with transparency standards. As a result, users of ATSS have obtained enhanced transparency on the trading of Government of Canada securities, and there is broad transparency of trading in benchmark corporate securities. Over the past year, discussions have been ongoing among market participants and securities regulators on the evolution of the regulatory framework and ensuring there is appropriate transparency provided on all fixed-income securities for all investors. Developments in Canada and abroad suggest that, while maintaining liquid markets is an important concern, a higher level of transparency could benefit investors in Government of Canada securities.

In 2006–07, the Government will continue to work with market participants and securities regulators to enhance the transparency of the Government of Canada securities market for retail and institutional investors.

Retail Debt Program

The retail debt program strategy is under review in light of the findings of an evaluation conducted by Cap Gemini Ernst & Young in 2004–05 and an internal review, and the evolution of the Government's needs and the retail marketplace. Options are being assessed that align the program with the evolving needs of the Government and Canadians. Further information on the retail debt program and a report of 2004–05 activities are available at www.csb.gc.ca.

Management of Domestic Cash Balances

The Government of Canada manages its cash balances in order to ensure that it has sufficient cash on hand to meet its operating and liquidity requirements. The cash balances are invested through auctions twice daily.

The bulk of the cash balances are invested through a morning auction. This auction incorporates a credit management system, using credit ratings, credit lines and collateral arrangements to manage credit risk, and a broad list of eligible counterparties to encourage more competitive bidding at the auctions. The afternoon auction is used to invest the Government's residual cash balances. This auction is uncollateralized and is limited to Large Value Transfer System participants.

In December 2005, the Government commissioned an external review of its cash management program under the treasury evaluation program. The review is considering the effectiveness of the program in ensuring that the Government has sufficient cash available at all times to meet its operating requirements while maintaining effective low-cost borrowing for the Government. The review is examining, in particular, the structure and operation of the program; participation on the part of banks, dealers and other market participants; and the management of credit risk associated with the investment of cash balances.

Foreign Reserves Management

The Government holds foreign exchange reserve assets in the Exchange Fund Account (EFA) to provide foreign currency liquidity and to provide the funds, if required, to help promote orderly conditions for the Canadian dollar in the foreign exchange market. The Government's foreign currency reserves are funded through foreign currency liabilities. The foreign currency reserve assets, and liabilities financing those assets, are managed within an asset-liability management framework.

This section addresses four areas falling under foreign reserves management: the investment of reserves, the funding of reserves, performance reporting and risk management.

Reserves Investment

In the Budget Implementation Act, 2005, the Currency Act was amended to enhance the management of the Government's foreign reserves portfolio and to reduce the risk of legal issues arising from antiquated drafting of some sections of the previous legislation. The amended act, which came into effect on December 30, 2005, improves the flexibility in managing the EFA by allowing investment in new asset classes, which will improve its risk/return profile. In 2006–07, the primary focus on the investment side will be to implement the new investment regime, as per the amended Currency Act.

A Statement of Investment Policy (SIP) has been developed and implemented, as required by the amended act. The SIP contains policies governing the acquisition, management and divestiture of assets of the EFA. The SIP allows for investment in two new short-term asset classes, commercial paper and certificates of deposits, as alternatives to other forms of short-term investment, particularly unsecured deposits. Investment in the new asset classes will increase the diversification of the portfolio and is expected to lower overall risk. Investment in these asset classes will commence in 2006–07.

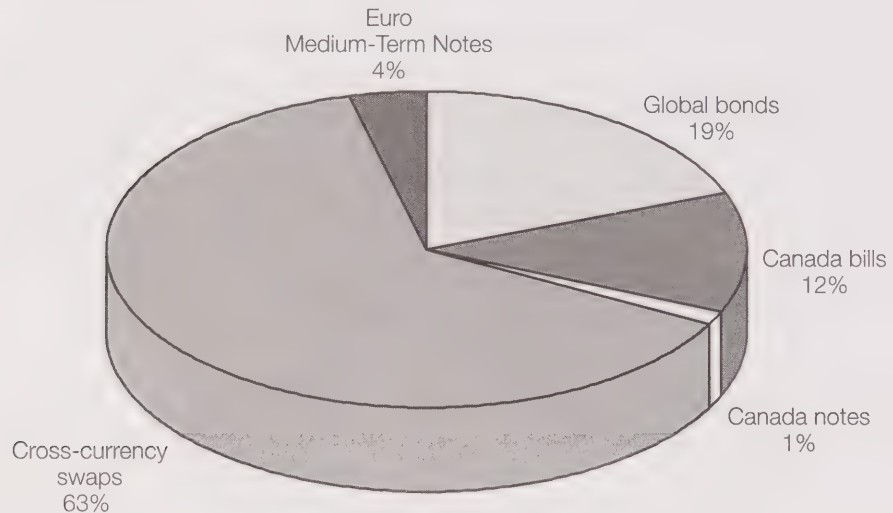
To strengthen the management of the EFA, an external review of the Account is underway under the treasury evaluation program. The focus of the review is to assess how Canada's reserves investment policies and practices compare to the practices of other sovereigns and large institutional investors and to identify areas of improvement.

Reserves Funding

The Government's foreign reserves are financed by foreign currency liabilities. The Government has access to a wide range of sources to fund its foreign currency assets. These sources include a short-term US-dollar paper program, medium-term note issuance in various markets, cross-currency swaps of domestic obligations, international bond issues, and purchases of US dollars in foreign exchange markets. Cross-currency swaps, which involve switching domestic liabilities for US-dollar and euro-denominated liabilities, have proven to be a particularly cost-effective alternative and have been actively used in recent years.

In 2006–07, the precise mix of funding sources will depend on a number of considerations, including relative cost, market conditions and opportunities, and the desire to maintain a prudent foreign-currency-denominated debt maturity structure. It is expected that cross-currency swaps of domestic obligations will continue to be the primary source of reserves funding.

Chart 8
Forecast Composition of Foreign Currency Liabilities
March 31, 2006



Note: Numbers do not add to 100% due to rounding.
 Source: Department of Finance Canada.

Chart 8 shows the expected composition of foreign currency liabilities at March 31, 2006.

Performance Reporting

Performance reporting is a framework for measuring, analyzing and evaluating financial performance of the investment and funding of reserves. The policy requires regular and timely reporting to senior management, the Minister of Finance and Parliament of the returns on EFA assets and the costs of associated liabilities.

Two principal measures of performance are used: cost of carry (an accounting-based measure which captures net interest income and realized gains/losses) and total return (a market-based measure that captures net interest income and realized and unrealized gains/losses). Several enhancements to the performance measurement framework were introduced in 2005–06, such as performance attribution analysis and the development of an external asset benchmark. In 2006–07, work will continue to further improve these measures, taking into account the results of the external evaluation.

Risk Management

The Government has in place a comprehensive risk management framework for identifying and managing financial risk, including market, credit, operational and legal risks related to the financing and investment of the foreign exchange reserves. Standards for risk control are high, market risks are immunized to the greatest extent possible, and high standards of credit quality and portfolio diversification are followed.

In recent years, the Government has continued to further strengthen its risk management framework by implementing collateral management frameworks for its cross-currency swap program and US-dollar deposit program. Collateral management systems are increasingly the norm in capital markets as a way of managing risk. Under the frameworks, high-quality collateral (e.g. cash, securities) is posted to the Government when its credit exposure to financial institution counterparties exceeds specified limits.

The Government employs measures of market risk exposure that are considered industry standards: stress testing and Value-at-Risk (VaR). Stress tests are used for evaluating the reserves portfolio performance under extraordinary circumstances in the market. VaR is a statistical measure for estimating potential losses of the reserves portfolio due to normal market movements, i.e. changes in interest and exchange rates. To aid in the measurement and monitoring of credit risk, credit risk measures such as actual and potential exposures and, more recently, Credit VaR, have been adopted. Credit VaR is a statistical measure for estimating potential losses of the reserves portfolio due to credit events, such as a counterparty's credit rating downgrade.

While the primary focus of risk management in recent years has been on market and credit risks, efforts in 2006–07 will be concentrated on developing risk measures for liquidity and operational risks.

Summary of the 2006–2007 Debt Strategy Plan and Intended Results

Debt Structure

Objective: *Gradually reduce the fixed-rate share of debt from two-thirds to a target of 60 per cent by 2007–08.*

Action for 2006–07:

- Continue to reduce the fixed-rate share of debt towards the 60-per-cent target.
- Increase the size of the treasury bill program from about \$131 billion in 2005–06 to approximately \$135 billion to \$140 billion in 2006–07.
- Issue about \$31 billion of bonds in 2006–07, about \$1 billion less than in 2005–06. Due to large bond maturities and continued cash management bond buyback operations, the bond stock is expected to decrease by some \$6 billion.
- Reduce the size of the buyback program, with a planned level of between \$7 billion and \$8 billion, roughly \$1 billion less than in 2005–06.
- Maintain a stable maturity profile.

Intended Result:

- ➔ Achieve lower debt charges, while continuing to prudently mitigate the risk to the budget framework.
- ➔ Facilitate market adjustment to changes in the bond and treasury bill programs.
- ➔ Prepare for the end of the transition to sustainable bond programs and preserve liquidity in outstanding issues.
- ➔ Limit the need to refinance a large portion of debt in any given period.

Domestic Debt Programs

Objective: *Maintain diversified sources of funding and a well-functioning market.*

Action for 2006–07:

- Continue regular issues of marketable bonds in four maturity sectors, treasury bills in three maturity sectors and a long-dated index-linked bond.

Forgo the 2-year auction in the fourth quarter of 2006–07.

- Change the dating of the 5-year benchmark maturity from September 1 to June 1 to make the new benchmarks fungible with old 10-year benchmarks, allowing the 5-year auction in the fourth quarter to be eliminated.

- Maintain the current new issuance benchmark target sizes for non-fungible 2-, 5-, 10- and 30-year bonds.

- Continue to borrow on a pre-announced basis and provide timely notices of government policy decisions.

- For regular buybacks, lower the minimum amount of outstanding benchmark bonds above which buyback operations will be conducted from \$6 billion to \$5 billion in all maturities.

Intended Result:

- ➔ Keep costs low and mitigate funding risk by diversifying borrowing across investor segments, instruments and maturities.

- ➔ Facilitate a reduction in bond issuance and maintain adequate liquidity in other key bond maturities.

- ➔ Maintain a liquid market for on-the-run issues and building-benchmark issues.

- ➔ Maintain transparency and efficiency.

- ➔ Increase the amount of bonds eligible for repurchase at buyback operations.

Ensure average turnaround times are less than 3 minutes for auctions and less than 5 minutes for buybacks. Reduce maximum turnaround times from 10 minutes to 5 minutes for auctions and from 15 minutes to 10 minutes for buyback operations.

Evaluate the merits of consolidation of some or all of the borrowing by major government-backed entities into government debt programs.

Continue research and consultations with market participants and regulators on the transparency of the market for Government of Canada securities.

➔ Enhance the bidding process and participation while reducing risk for market participants.

➔ Ensure the borrowing framework used by the Government is effective and efficient.

➔ Support an appropriate level of transparency in the Government of Canada securities market.

Foreign Reserves

Objective: *Improve the cost-effectiveness of funding foreign reserve assets.*

Action for 2006–07:

Continue to use cross-currency swaps as the primary source of reserves funding.

Implement a new investment regime and invest in new short-term asset classes.

Intended Result:

➔ Keep the cost of carrying reserve assets low.

➔ Improve the risk/return profile of the portfolio.

Glossary

asset-liability management: An investment decision-making framework that is used to concurrently manage a portfolio of assets and liabilities.

average term to maturity: The average time remaining before debt matures, taking only principal amounts into account.

basis point: One-hundredth of a percentage point (0.01 per cent).

benchmark bond: Specific issue outstanding within each class of maturities. It is considered by the market to be the standard against which all other bonds issued in that class are evaluated.

budgetary surplus: Occurs when government annual revenues exceed annual budgetary expenses. A deficit is the shortfall between government revenues and budgetary expenses.

buyback on a cash basis: The repurchase of bonds for cash. Used to maintain the size of bond auctions and new issuance.

buyback on a switch basis: The exchange of outstanding bonds for new bonds in the current building benchmark.

Canada bill: Promissory note denominated in US dollars, issued for terms of up to 270 days. Canada bills are issued for foreign exchange reserves funding purposes only.

Canada Investment Bond: A non-marketable fixed-term security instrument issued by the Government of Canada.

Canada note: Promissory note usually denominated in US dollars and available in book-entry form. Canada notes can be issued for terms of nine months or longer, and can be issued at a fixed or a floating rate. Canada notes are issued for foreign exchange reserves funding purposes only.

Canada Premium Bond: A non-marketable security instrument issued by the Government of Canada, which is redeemable once a year on the anniversary date or during the 30 days thereafter without penalty.

Canada Savings Bond: A non-marketable security instrument issued by the Government of Canada, which is redeemable on demand by the registered owner(s), and which, after the first three months, pays interest up to the end of the month prior to cashing.

Contingency Reserve: Is included in the budget projections primarily to cover risks arising from unavoidable inaccuracies in the models used to translate economic assumptions into detailed budget forecasts, and unpredictable events. If not needed, it is used to pay down the public debt.

Cost-at-Risk: A measure based on the statistical distribution of debt charges that enables risk to be quantified in terms of the maximum costs that could occur within a specified probability range in a particular year.

cross-currency swap: An agreement that exchanges one type of obligation for another involving different currencies and the exchange of the principal amounts and interest payments.

duration: Weighted average term to maturity of a bond's cash flow, used as a measure of interest rate sensitivity.

electronic trading system: An electronic system that provides real-time information about securities and enables the user to execute financial trades.

Exchange Fund Account: A fund maintained by the Government of Canada for the purpose of promoting order and stability of the Canadian dollar in the foreign exchange market. This function is fulfilled by purchasing foreign exchange (selling Canadian dollars) when there is upward pressure on the value of the Canadian dollar and selling foreign exchange (buying Canadian dollars) when there is downward pressure on the currency.

federal debt: Total liabilities less financial and non-financial assets.

financial requirement/source: Measures the difference between cash coming in to the Government and cash going out. In the case of a financial requirement, if cash on hand is not used, it is the amount of new borrowing required from outside lenders to meet the Government's financing needs in any given year.

fixed-coupon marketable bond: Market debt instrument issued by the Government of Canada and sold via public tender. These issues have a specific maturity date and a specified interest rate. All Canadian-dollar marketable bonds pay a fixed rate of interest semi-annually and are non-callable. They are transferable and hence can be traded in the secondary market.

fixed-rate debt: The share of the gross debt that is maturing or being repriced in more than 12 months.

fungible bond: A bond that has the same financial attributes as another. Fungible bonds are interchangeable.

government securities distributor: Member of a group of investment banks and dealers through which the Government distributes Government of Canada treasury bills and marketable bonds.

gross public debt: Total amount the Government owes. It consists of market debt in the form of outstanding securities such as treasury bills, marketable bonds and Canada Savings Bonds, non-market debt owed mainly to the superannuation accounts for government employees, and other current liabilities.

interest-bearing debt: Consists of unmatured debt, or market debt, and the Government's liabilities to internally held accounts such as federal employees' pension plans.

marketable debt: Market debt that is issued by the Government of Canada and sold via public tender or syndication. These issues can be traded between investors while outstanding.

market debt: The portion of debt that is funded in the public markets. It consists primarily of marketable bonds, treasury bills, retail debt and foreign-currency-denominated bonds and bills. It also includes bonds issued to the Canada Pension Plan and obligations related to capital leases, although these are not borrowed from the market or actively managed.

net debt: Gross debt, net of financial assets.

non-marketable debt: Market debt that is not tradable and that is issued to retail investors (Canada Savings Bonds and Canada Premium Bonds).

non-market debt: Consists of the Government's internal debt, which is, for the most part, federal public sector pension liabilities and the Government's current liabilities (such as accounts payable, accrued liabilities, interest payments and payments of matured debt).

primary market: The market in which securities are initially sold or offered.

Real Return Bond (RRB): Government of Canada RRBs pay semi-annual interest based upon a real interest rate. Unlike standard fixed-coupon marketable bonds, interest payments on RRBs are adjusted for changes in the Consumer Price Index.

secondary market: The market in which previously issued securities are traded, as distinguished from the new issue or primary market.

sovereign market: Market for the debt issued by a government.

treasury bill: Short-term obligation sold by public tender. Treasury bills, with terms to maturity of 3, 6 or 12 months, are currently auctioned on a biweekly basis.

turnover ratio: Volume of securities traded as a percentage of total securities outstanding.

yield curve: Graph based on the term structure of interest rates, plotting the yield of all bonds of the same quality with maturities ranging from the shortest to longest term available.

